

Global Fixed Income Macro Outlook Tunnel vision

- The consensus remains short despite positive bond market price action
- With positioning unchanged, pain trades could continue to surprise
- The US debt ceiling, winter virus and China slowdown will be key

Summary

Three months ago, in '[Inflation Hyperventilation](#)', we questioned the prevailing narrative of higher bond yields, bear steepening, a secular inflation breakout, and a sustained boom in growth amid the end of the pandemic. Since then, 10-year Treasury yields have *fallen* by 25bps (more versus the forwards), and the US 5s30s curve has flattened by 35bps. Coming into 2021, we noted in '[Just another range trade](#)' that both the sellside and buyside consensus was more concentrated than in any year we could remember. That consensus may come under further pressure, as the same pain trade that hurt those in bear steepeners over the past three months still looks crowded.

Harvard and Cornell University psychologists Christopher Chabris and Daniel Simons famously showed in their 'Invisible Gorilla experiment' the role of selective attention – or tunnel vision – in cognitive information filtering. In bond markets today, tunnel vision seems prominent with many

overly focused on their priors, rather than considering the idea that other drivers may come to the fore.

For example, many finance professionals see evidence of higher economy-wide inflation from their personal spending experiences, even though their own CPI baskets

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sit in the top 1% of income cohorts. Furthermore, home prices in desirable locations are up 10-20% in many economies, yet rents chug along at 2-3%. Used cars, which outsell new cars by 3:1 in volume terms in the US, have seen price falls for three months now – a key indicator given its contribution to year-on-year CPI data in the spring. What market professionals notice from their personal experience is not necessarily what will matter economywide.

Second, many investors take a cyclical view, when more secular-oriented economists, such as HSBC's Stephen King and Morgan Stanley's Seth Carpenter, have recently pointed out there are evident two-way risks to inflation.

Third, on valuations, some investors still cling to a link between nominal GDP and bond yields, even though nothing other than supposition suggests this is required. It may have worked well in the 1980s and 1990s in developed markets (DM), yet it has failed spectacularly in increasingly internationalized markets since 2011, and failed once again in the most recent three months. More surprisingly, many look at nominal GDP for 2021 or 2022 and compare it to yields of 30-year bonds (maturing in H2 2051), suggesting there should be some relationship. Yet if the Fed does not raise rates until Q4 2022 (from 0.25% to 0.50%), the nominal GDP of the next 12 months is simply irrelevant, in direct terms, to the bootstrap mathematical pricing of bond yields. Others point to low real yields and yet, as HSBC's Steven Major has pointed out, they are simply a residual of central bank-influenced nominal yields and market-implied inflation expectations. The commentariat is drawn to *yield direction*, when the bigger moves are in curves. (The lessons of the 2005 conundrum, of curve behavior early on in an expansion, appear to have been forgotten.) On tenors, many look at the 10-year segment, when the more pronounced price action in the US has been 5s30s flattening and the asymmetry on the short side is in 2s. Many focus on US yields, when capital gain opportunities look much more attractive in China. On the short side, there is arguably more asymmetry in Germany. Non-US cross-market looks the best fixed income trade to us from here.

'The bond community, it seems, has become selective in its attention, resolute in holding its priors, narrow on the geographic opportunity set, and stale on policy focus'

Fourth, on policy, there is tunnel vision on tapering: our analysis shows the impact is divergent on real yields and breakevens, yet the consensus focuses on nominals. The taper question, a serious topic back in March, now looks like

yesterday's news: it has been far more widely flagged than 2013. Where will the surprise be? Markets should broaden their surveillance on policy: brink(wo)manship on the upcoming debt ceiling, the German election and China property tightening may be more influential.

Finally on the virus, the market assumes a 'back to normal' situation within a couple of months, despite evidence from Israel, Scotland and Florida, among others, that this is far from assured. Observations are often made at the country level, when patterns that may portend more are regional, particularly given the staggered schedule of back-to-school dates. We have seen a virus flare at the start of the past three school terms. Alternatively, the virus might peter out in DM in a couple of weeks, or it might be a tough winter. But who could honestly place a sensible bet on each outcome? The travails of recent forecasting at Imperial College London show just how careful even professional epidemiologists need to be in distinguishing possibilities from probabilities. Yet there is evident bias in the consensus approach: we count 12 times in the past 18 months when a 'back to normal' assumption has dominated, only to be upended.

All in, the bond community, it seems, has become selective in its attention, resolute in holding its priors, narrow on the geographic opportunity set, stale on policy focus and lacking in a cohort-based approach to household balance sheet analysis. There is plenty of positional evidence of herding and groupthink, with few apparent lessons learned from Kindleberger.

To be sure, the risks are not one-way. We think a broader range of scenarios is more appropriate. Nominal Bund yields may yet rise amid upcoming German elections. Globally, the ongoing manufacturing pipeline and inventory restocking may be powerful. Leisure and hospitality wages are rising sharply.

We prefer to stick to our contrarian and value-led philosophy, which means a focus on valuations and positioning. We are weary of bear steepeners in the US. In Bunds, there is a bit more valuation asymmetry to justify a short, at least when 10-year yields are close to the deposit rate. But we think there are more interesting risk-return trades than simply directional selling of Bund futures.

In credit, we see little scope for capital gain with many high yield (HY) issues trading to call. However, we think EUR investment grade (IG) remains the best protected amid ongoing ECB buying. Moreover, swap spreads have some narrowing potential. The biggest questions, highlighted by pronounced volatility across both IG financials and HY property since April, are in China credit.

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Macroeconomic and policy outlook

How steep will the descent be from the growth peak?

Growth outlook: past its peak

While the service-sector-led 'reopening trade' performed up to May 2021, bond market questions have arisen in Q3. The data is now more mixed – strength in some high-frequency indicators, but sharp falls in the expectations components of surveys amid the delta variant. In parts of Asia-Pacific, a zero-tolerance virus strategy has delivered a more pronounced slowdown (see China, Australia and New Zealand, for example). In China, this has been amplified by regulatory tightening. Global growth may have passed its peak, but how severe might a slowdown be?

On the positive side, prior monetary and fiscal support should help, in part through the multiplier effect. Large unfilled order books should sustain manufacturing. While supply chain disruptions reduce current production – check out autos – high backlogs and low inventory levels can have a growth-smoothing effect as deliveries are pushed into future quarters. Inventory restocking may accelerate as businesses seek to avoid potential future missed sales due to a lack of stock.

'Putting consumer balance sheets in context, the vast majority of households in most DM economies have large shortfalls (not excesses) in retirement savings'

Then there is the consumer balance sheet debate. We question whether pandemic-related consumer savings should be classified as 'excess' savings. Excess to what? Only to the prior path. Yet choice of words matters as it influences future economic thoughts and forecasts. Putting consumer balance sheets in context, the vast majority of households in most DM economies have large shortfalls (not excesses) in retirement savings. Consumer credit data in 2021 shows plenty of debt reduction. The extraordinary rise in recent years in the age of first-time buyers in many DM property markets (in some countries, first-time buyers are now in their 40s) means many workers in the first two decades of their careers need to accumulate savings for deposits. Covid-era savings are skewed to age cohorts with a lower propensity to consume (think older, not just wealthier).

Which brings us onto inequality: many in the financial community have not recognized that nearly half of most DM populations made few Covid-era savings at all (and many saw savings drop). Determining future spending patterns from aggregate household statistics is arguably an illusion when balance sheet variation by income quintile is so pronounced. The Fed seems to have acknowledged this, amid some realpolitik, with their choice of the 2021 Jackson Hole conference theme. All in, we think many consumers (and businesses) will likely retain a precautionary saving stance – as confirmed by a recent survey by the Dutch central bank. Neither is this debate new. After the GFC, both sellside and buyside forecasts of spending based on labels of 'cash piles' proved strikingly over-optimistic as prior lessons from Japan went unheeded. These in turn, were treated over-optimistically at the time. Might the same forecasting error of too much emphasis on the cyclical relative to the secular be made a third time?

On the downside, the potential hurdles include the looming debt ceiling timeline in the US and elections in parts of Europe. As for policy, we note the first signs of tax increases (see the UK) and regulatory crackdowns (China).

Meanwhile, service-sector spending seems tied to the path of the virus. While DM vaccination rates have been encouraging, they as yet appear insufficient (see Israel, for example). Amid the time decay in vaccine efficacy and debate over booster shots, one can't exclude a larger-than-expected rise in hospitalization rates into the Northern Hemisphere winter, impacting mobility and hence services growth. The consensus does not seem to discount this risk sufficiently in our view and continues to extrapolate a persistent return to full global reopening. There is also the tail risk of new escape variants.

We count 12 episodes since early 2020 when investors forecast the end of the virus: in January 2020, Covid-19 was viewed as similar to SARS; in March some proclaimed: "it will be over by Easter". In summer 2020 there was the infamous 'Prague dinner' celebrating the pandemic's apparent end. Then, after vaccine discovery, the alpha strain was assumed to be the main risk; yet in Q3 2021, R rates required revisions due to delta. In July 2021, an academic paper at the University of East Anglia even proclaimed that once Scotland were knocked out of the euro football championship, the virus in Scotland would be over. Bond traders, already short duration in stale reopening trades, seized on the idea. The fall in Scottish new-case data lasted four weeks.

None of this means that extrapolating the ongoing prolongation of Covid disruption is the answer. The Spanish flu, for instance, cleared up after around two-and-a-quarter years. But assuming straight-line economic recovery seems equally dubious. A recent study,¹ highlighted by our own in-house specialist Richard Purkiss, concluded that infection (mucosal immunity) is substantially more powerful than vaccination (systemic immunity) in offering protection against future infections. This may alter the consensus view of virus exit timelines, and country-level progress, based on natural exhaustion.

In EM, there is higher sensitivity to China's growth path and monetary policy tightening in many economies amid increased inflation. The good news, as highlighted in an analysis by Richard, is that some EM countries now appear to have high levels of immunity built through prior infections. This may offset or even partially reverse the challenges experienced in EM with reliable vaccination procurement.

'Chinese policymakers continue to walk a tightrope of attempts at deleveraging while avoiding a sharp slowdown'

Three months ago, we warned that China was likely to slow, as the measure we track to gauge the combined impulse from monetary and fiscal policy to future growth had turned negative. Historically, this has portended slower demand growth six to nine months later. Chinese policymakers continue to walk a tightrope of attempts at deleveraging and a need to avoid a sharp slowdown. This year's property sector policy tightening, with caps on bank lending and mortgage rate increases, have started to bite. The recent fiscal loosening, targeted easing by the PBoC as well as window guidance on bank lending to non-property sectors, demonstrate an intolerance to growth that is too low. But this may be insufficient to avert a meaningful slowdown.

China construction spending drove the world's recovery in 2009, its slowdowns in 2015 and 2018, and its mini-recoveries in 2016 and 2019. At the very least, current events challenge the bullish commodities backdrop (recall sellside forecasts of USD 100 oil just 12 weeks ago?). We reported last quarter that, amid peak optimism and commodity speculation, lumber prices had doubled year to date, then subsequently fallen right back to 1 January levels. Three months later, they have now fallen 40% year to date.

¹ "Comparing SARS-CoV-2 natural immunity to vaccine-induced immunity: reinfections versus breakthrough infections", Sivan Gazit, Roei Shlezinger, Galit Perez, Roni Lotan, Asaf Peretz, Amir Ben-Tov, Dani Cohen, Khitam Muhsen, Gabriel Chodick, Tal Patalon

Is it outlandish to suggest that global inflation risks might be two way?

We continue to think the combined fiscal and private-sector credit impulse for the US and Eurozone will probably follow China into negative territory in 1H 2022. All considered, we think it will be increasingly challenging for economic growth to meet consensus hopes into 2022.

Inflation debate continues but has subtly shifted

The causes of the elevated headline inflation prints in many DM countries are well known: reopening in travel and leisure, supply chain disruptions, pandemic-related behavioral shifts (e.g. in used cars in Q2) and commodity prices amid mathematical year-on-year base effects. Yet now, supply chain disruptions and labor shortages are increasingly replacing fiscal stimulus and excessive money supply growth as the key arguments behind an upcoming inflation regime shift. This looks like 'thesis rotation' with new drivers adopted to reinforce existing priors, as the original arguments become stale.

For US core inflation, rents look key. One argument is that the rise in house prices and reduced vacancy rates will spill over. We would argue, though, that historic regime shifts in inflation occurred in the context of a feedback loop developing between inflation expectations and wage growth – and that US housing already seems to be slowing down if mortgage applications are a useful guide. Hence, we – much like the Fed – are closely watching wages. It remains to be seen whether the headline-grabbing move higher in wages for lower-paid jobs, in the hospitality sector for instance, will have legs once the season for outdoor dining passes. For now, metrics like the Atlanta Fed Wage Tracker have been high relative to still-elevated unemployment, but their metric on median wage growth has remained in a narrow range since 2016. Moreover, we agree with the Bank of England's Ben Broadbent that resolving the labor market mismatch and required reallocation won't happen overnight. Meanwhile, stories on sector-specific labor shortages will continue to dominate the headlines.

In the Eurozone, headline inflation has also risen to fresh 10-year highs and is set to rise somewhat further in Q4. The data is affected by technical factors which should disappear next year, i.e. the re-weighting of HICP items and German VAT base effects. As in the US, wages are key. For now, underlying wage growth seems subdued, amid still-substantial unemployment (including the hidden unemployment due to short-time working schemes). That

said, we note upward pressure in some Northern European countries including Germany, where many more businesses cite labor shortages compared to Southern Europe.

Balance sheet policy: a taper, no tantrum

The nexus between fiscal policy and monetary policy remains in place, with sizable fiscal deficits in many economies still being mostly funded by central banks.

In the US, the slowing in the fiscal *impulse* persists, even if final agreement on the forthcoming 'human infrastructure' plan comes close to the proposed USD 3.5 trillion number. Unlike earlier packages, a large part of these plans will be tax financed – and they will be spread over many years. The same slowing looks set in the Eurozone too, even as the support via the NextGenerationEU recovery fund flows to Southern and Eastern Europe.

However, with 2021's recovery, central banks are shifting towards unwinding some of their exceptional policies. The RBNZ has halted its bond buying, and the BoE and BoC have further trimmed the pace of their net purchases.

The Fed has (finally) begun to discuss the tapering of its sovereign and MBS purchases, and has already wound down its corporate bond portfolio. The glacial and incremental approach to communication means they have succeeded thus far in avoiding a reprise of 2013.

An official announcement may come in November, with implementation starting in December. Yet note that coupon issuance of US Treasuries is expected to come down by approximately USD 1 trillion next year, which should be an important counterargument for those worrying about net supply. This seems another example of selective attention: why the relentless focus on USD 1 trillion of asset purchase tapering and almost no focus on USD 1 trillion of coupon cuts? In any case, both historical analysis and relative valuations suggest real yields are more vulnerable to upward taper pressure than nominals.

The ECB still believes it is premature to talk about a QE exit. It has 'recalibrated' the net monthly purchase pace of the PEPP, though, after the recent acceleration into July. By year end, pandemic permitting, a gradual phasing out of PEPP by mid-2022 might be agreed. However, to avoid a QE cliff and ensure that financing conditions remain favorable enough next year, the current monthly run rate of EUR 20bn under the 'regular' APP program might be temporarily boosted. The crucial question is whether the forward guidance on APP (i.e. that it is expected to continue until "shortly" before the first rate hike) is maintained. We are not so sure. Either way, it seems the

ECB will be buying bonds across the Euro Agg spectrum under one acronym or another for years.

Meanwhile in China, where PBoC balance sheet expansion has been much more limited during the pandemic, the central bank has shifted to an easing stance given the economic slowdown. Recent measures include a broad-based cut in banks' reserve requirements (RRR) and RMB 300bn in additional relending to support SMEs. While the PBoC keeps signaling that further broad-based measures are unlikely, the risks seem skewed to balance sheet expansion rather than compression.

Interest rate policy: first movers start to move

We still think most G-10 central banks will follow the Fed's normalization blueprint of 2013-2015, with rate hikes coming only after net asset purchases have finished (see our [Central Bank Watcher](#)).

Rate hikes in the next six to nine months therefore still look confined to early movers such as Norges Bank – where sovereign QE has not taken place – and the RBNZ, which seems eager to start its rate-hiking campaign.

If started in December, Fed tapering would take until autumn 2022, pointing to H1 2023 as the earliest realistic date for a first rate hike.

The ECB's forward guidance – aligned to the new 2% inflation target in July – still hints at a possible rate cut. We see risks skewed to the ECB being on hold for longer, but as it will take time before the transitory view on inflation transpires to be correct, we think there's still room for markets to price in a bit more rate tightening in coming months (just in case it's not transitory!), but any move here would be modest.

Notably, in a slight detour from the Fed blueprint, the BoE signaled at their August 2021 MPC meeting that they would consider stopping fully reinvesting maturing holdings when the Bank Rate had risen to at least 0.5%, and would consider actively selling Gilts when the Bank Rate reaches 1.0%. This hint at QT, and possibility of an embrace of NIRP in the future, helps explain the relative flatness of the UK yield curve.

In China, the PBoC seems of the view that policy rate cuts are not necessary for now, and that targeted easing support for SMEs will sufficiently reverse the downturn in growth amid moderate underlying inflation pressures. We doubt this, and believe risks are firmly skewed to lower rather than higher policy rates in the coming 12 months.

Rates strategy

Yield bounce finds potential roadblocks

Difficult to find bearish drivers for rates

With yields bouncing from early-August lows, we question how much this could continue given potential obstacles in the macro and policy outlook. On the US debt-ceiling standoff, for example, while brokers seem to be focused on its potential for pushing up T-bill yields, we think that is a symptom rather than an outcome and we give more weight to the substantial downward impact on longer-term yields visible in 2011 (and to a lesser extent 2013). This may turn out a non-event. If not, as in 2011, safe-haven buying will likely take over rapidly. The market is simply not positioned for extended brinkmanship.

As Fed tapering has been flagged to the point of tedium, it will be difficult to see a significant bearish response to an eventual announcement. For the ECB it should, in theory, be easier to deliver a hawkish surprise. In reality, we view such a shock as unlikely.

'With official rates near the ELB, any risk aversion will bring bull flattening'

Longer term, the gradual shift in monetary policy stance will likely have an impact on rates, but the degree to which this happens will depend squarely on the expected level of neutral interest rates (r^*). For some markets that might even result in a further trend-like decline in long-term rates. Take China, where the elevated overall indebtedness and demographic outlook will require lower equilibrium policy rates. Current events could even accelerate this move.

For valuations, we view the outlook for official rates as an important anchor. For the Fed there are circa 75bps in rate hikes priced in for September 2023, around 15bps higher than before the June FOMC. We find a close relationship between front-end futures pricing and the 10-year yield. This suggests US 10-year rates could rise to around 1.6%. On positioning, the ongoing consensus underweight seems particularly dominant in the long end. In that light, even the 1.6% level might be tough to reach without a new catalyst.

In due course, much more could be priced in for the Fed, but we think it is too early for that. Past experience has shown that in more pronounced repricing episodes, the 2-5-year maturity segment tends to lead. The curve analysis presented in our [June outlook](#) supports the assumption that it is difficult for US long-term yields to rise above the

forwards when curves are steep. Any move upward in US rates should thus most likely be a flattening trade, as short-end yields rise. Alternatively, with official rates near the ELB, any risk-aversion move would bring long-end flattening. Curve strategy therefore seems clear to us.

In China, the market is currently pricing in modestly higher official rates on a one-year horizon. Even so, the market's reassessment of the policy outlook has helped steer China government bond yields lower. Any hesitation in the market to price in further cuts could make it challenging for 10-year CGB yields to drop much below 2.75% shorter term. Net supply could increase too, particularly if Chinese authorities seek to raise the credit impulse into 2022. See the recent increase in state and local-government bond issuance. Still, further out we see potential for CGBs to rally further, especially cross market, and the skew to left-tail risks could augur much more.

As per our philosophy, we tend to see better risk-return opportunities in cross market and curve, than in outright direction. We think the potential for yields to rise is most asymmetric in the short maturities and the belly of the US and German curve. By contrast, the back end, particularly in the US, looks more stable. We therefore like flatteners in the US, with a short in 2-5-year maturities. On the German curve we have increased our 2-5 steepeners. The best long-side opportunities are in on CGBs, particularly with the potential skew toward much lower yields. Finally, in Japan, we remain underweight.

For inflation-linked breakevens, although lingering inflation uncertainty might support risk premia, already-rich valuations, especially in the UK and the US, pose a risk of a repricing. US levels seem particularly in focus now that the Fed is tiptoeing so slowly towards tapering. A key lesson to us from the 2013 taper tantrum is that BEIs peaked in the run up to it. Fed communication since June has shown there are much tighter limits to the FAIT regime than the sellside assumed when they penned their breakeven widener trades for 2021, with concrete core PCE levels and timelines. Might it even be that FAIT was in part a politically expedient response to unwelcome interference in central bank policy from the Trump administration that is now no longer required? In light of new facts, as Keynes reminded, the Linker market may need to change its mind.

Fixed income asset allocation

Sideways credit spreads in DM markets show that capital gain potential has now dried up. The big picture from here in IG is sideways or wider. For swap spreads and EUR AAA AAs, some tightening is possible. Meanwhile, China credit is where the action is.

Credit markets – all eyes on China

Since the start of Q2, per ICE BofA index data, the range in USD IG financial spreads has been 12bps, in euros 7bps and in Asia 105bps. In high yield, the equivalent numbers are 42bps, 26bps and 404bps. In the China high yield corporate index it has been 652bps – we think it is fairly clear where we should focus this quarter!

The question in our minds is whether we are about to see the unwind of one of the largest credit bubbles in history, or whether this is one more false alarm in the long history of China's state-directed credit system.

'Are we about to see the unwind of one of the largest credit bubbles in history, or is this one more false alarm in the long history of China's state-directed credit system?'

First some background. Ever since Deng Xiaoping, the mix of private sector economy and market activity, in a still nominally Communist country, has risen. Since 2000 (using the excellent BIS debt statistics) China private sector debt has risen from USD 1.2 trillion to over USD 34 trillion. But might these numbers even underestimate the boom? On the denominator, China's own leadership has referred to GDP as a policy goal (i.e. an aspiration) rather than a true statistical measurement. On the numerator, as Michael Pettis points out, Galbraith's concept of 'the bezzle' suggests debt may be substantially higher. China's GDP clearly grew in H1, but as of end-2020, the PRC's private sector debt-to-GDP ratio at >200% is higher than every large comparable global credit bubble in the history of the past three decades, including the US and Spain in 2007, Thailand and Korea in 1997, and the UK and Japan in the 1980s. These are simply the reported facts, across geography and time.

Now for the scenarios. Experienced and credible macroprudential China analysts have long wondered when secular economic reality would receive a cyclical test. Contrary to prevailing wisdom post-GFC on the government debt side, there is no magic number where debt becomes

unsustainable. Rather, it is the point at which too many bottom-up credit rumblings and top-down concerns conspire to tip market sentiment from accumulation, greed and borrowing (in other words credit creation) to risk aversion, lower bank lending, rollover risk and ultimately credit crunch.

China's externally closed financial system, command economy, state-directed policy bank lending and strict adherence to technologically enforced one-party rule of law have in our view prolonged the credit expansion. But we are skeptical that one-party political law can subvert *economic law* in the long run. Unless prices are fixed (a Soviet interpretation of Communism), they float. While China operates a hybrid system, without going Soviet, we question whether one can regulate human psychology, incentives, ownership structures and market prices ad infinitum.

Timing secular turning points in credit creation is always tricky. Smart analysts pointed to unsustainable debt in the US in 2004, only to be on the wrong side of a trade for three years. The reaction of policymakers matters, as does market positioning. But after years of credit accumulation, signs of bottom-up trouble (think Creditanstalt, IKB etc.) alongside top-down sectoral slowing, tend to occur. In this respect, we view the idiosyncratic events in the financial and property sector over the summer as potential evidence of a pattern, rather than necessarily separate idiosyncratic events. The performance of single-B China property names over recent weeks, and the rise in sector and ratings dispersion, suggests our concerns may be broadening. While this might yet prove another false alarm (as in 2015 and 2018), we note the path of bottom-up lender (Huarong), borrower (Evergrande) and investor headlines.

We've had the first two. Spread levels in China HY property – which are now at recessionary levels – must surely have led to market pain, suggesting we may get the third. To be clear, we do not believe the capital injection from Citic into Huarong portends much about the systemic roadmap. Recall that the rescue of Bear Stearns in March 2008 led to a temporary market rally, but it did not unwind years of credit accumulation. In the short term, investors react to headlines, but in the long term, themes dominate. Stay tuned.

In this context, we continue to be overweight EUR IG with its ECB help, while avoiding the longer duration and more volatile USD IG, and having a net zero weight in high yield globally, as a majority of issues are now trading to call. This makes for a conservative overall portfolio stance. There are various channels via which China credit volatility could spread. With western DM spreads testing post-GFC lows (and in some cases heading towards 2003-07-era lows), any left-hand tail risk (e.g. some heart flutter on the US debt ceiling) is simply not priced. We would suggest that domestic fundamentals in the US and Eurozone are largely irrelevant to market pricing, in the scenario that China events end up reversing the benign influence of years such as 2009, 2016 and 2019. Focusing on the likes of US earnings, which look back to macroeconomic information that is already known, and underestimating the global role of China in cyclical developments, strikes us as another example of tunnel vision. It's not just about the basketball!

Periphery growth strong but political and taper risks loom

With NGEU funds flowing and economies emerging from the coronavirus slump, the growth outlook for the periphery as the main beneficiaries of NGEU grants seems well supported. The ECB through its PEPP program is providing huge support by scooping up significant amounts of Italian, Portuguese and Spanish bond supply. BTPs and to a lesser extent Spain and Portugal are therefore sensitive to developments around the size and composition of ECB purchases. In fact, a taper of ECB purchases in 2022 is likely to have an adverse impact on peripheral spreads as valuations are no longer compelling. Specifically in Italy, the government led by former ECB President Mr. Draghi has had a successful start, but the market is well aware of this by now and the good news should be priced in. With budget negotiations looming in autumn, political uncertainty could increase again and cracks could appear in Mr. Draghi's coalition. We are therefore cautiously positioned with a modest underweight in Italian BTPs and in Iberia.

'Many EM central banks have raised rates, but we would argue that only Brazil has done this in a credible manner'

EM debt: weakening fundamentals

The EM fundamental outlook is turning weaker with PMIs softening from peak levels along with declining fiscal stimulus or monetary support among the major central banks. Inflation data remains top of mind for the likes of Turkey and Brazil, but inflation figures will most probably be peaking across EM in the next two quarters. Also, there are still high numbers of (delta) Covid-19 cases in certain EM countries such as Malaysia, Thailand and Philippines, while overall full vaccination rates are low. But market factors have been able to trump fundamentals in the past year and could still be positive for several months. Historically, as US real yields remain at their lows, EM flows have been supportive. With US 10-year real yields still below -1.05%, this remains favorable near term. The growth outlook may be weakening, alongside tighter financial conditions. Recent Chinese manufacturing data, as well as more prolonged supply chain constraints across Asia, suggest the outlook could even worsen into 2022. While tapering should not surprise, any pricing in of cumulative future Fed hikes should be watched carefully.

Many EM central banks have been raising policy rates in advance of the Fed. We have seen rate hikes in (among others) Chile, Brazil, Mexico, Hungary and Russia despite ongoing virus waves. Perhaps the most extreme case is Korea, where even a rapid rise of delta cases did not stop the central bank from hiking recently.

One feature of the Covid-19 shock is that on the surface, some important EM fundamentals have improved, in particular current account dynamics. The consensus typically interprets a combination of improving external trade data and rising official rates as positive for EM assets, but we would caution against placing too much weight on both developments. First, as economies get into lockdown, current accounts improve simply due to weaker consumption leading to an implosion of imports and better terms of trade. Re-opening of those economies will reverse a big part of those improvements. Second, many EM central banks have indeed raised rates but we would argue that only Brazil has done this in a credible manner. Other central banks have increased rates marginally, so more probably needs to happen there to make it a credible argument. We remain cautious on EM fundamentals. The overall betas of our macro strategies are underweight spread risk, including EM hard-currency spreads.

FX: We don't participate in USD bashing

In FX, we remain unconvinced by the fashion to position for the reflation trade via cyclical and EM FX. In our opinion it is very hard to characterize the current economic environment

as offering a classic reflationary setup. First, global data surprises are getting to negative levels not seen since early 2020. Economic forecasts continue to be adjusted downward in tandem for most countries and regions.

Second, the virus still brings large uncertainties from an economic perspective. Third, next to being inflationary shorter term, supply bottlenecks may also be quite damaging for growth longer term, as excess inflation weighs on consumption and production. Finally, we do observe the material slowdown in China. Given it is such an important engine for global growth, the slowdown in China probably explains why global trade data has been deteriorating despite mobility indicators generally improving. In our view it is very difficult to state that the loss of momentum is simply the result of the virus. There seems to be more to it. Hence, we remain cautious on cyclical and EM FX.

'We keep a conservative stance in FX and favor more idiosyncratic plays within our universe'

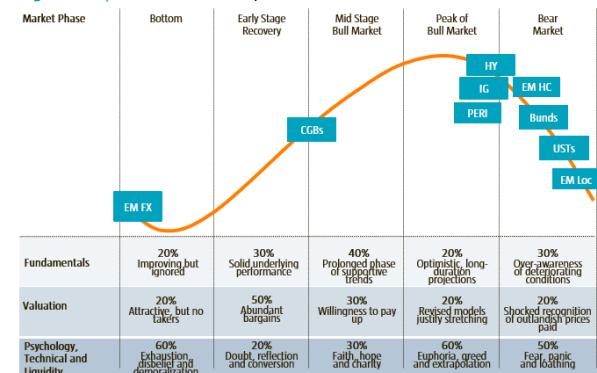
The USD remains an interesting case. The consensus view is still for further depreciation, though we note that has moderated in expected magnitude since the start of the year. The typical arguments are the same as those the pro-inflation camp tends to use: structurally higher levels of inflation in combination with a slow-moving Fed lead to much lower US real yields versus other currencies. We would caution against this view for a number of reasons. First, we think many arguments behind the structurally higher inflation debate are poorly constructed, as we have argued before. Second, we think currencies tend to trade in

regimes and hence respond to different drivers. Real yield spreads matter but so do current accounts, relative central bank balance sheet stocks and flows, etc. And third, with apparent backpedaling on FAIT, the Fed does not appear willing to tolerate that much excess inflation, which indicates that the consensus underappreciates the possibility of higher real yields instead of much lower yields.

Combining these arguments, we keep a conservative stance in FX and favor more idiosyncratic plays within our universe instead of directional positions on USD or cyclical/EM FX.

Asset class positioning

Figure 1 | The market cycle



Source: Robeco, September 2021

We wish to thank Helen Qiao and Janice Xue (BAML), Yi Xiong and Linan Liu (Deutsche Bank), Seth Carpenter (Morgan Stanley) and Richard Perkins (Robeco) for contributing to a productive and insightful quarterly outlook session.

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