



## Global Fixed Income Macro Outlook Inflation hyperventilation

- Inflation debate rages as year-on-year data recovers from lockdowns
- Neither the Fed nor the ECB are in a rush to tighten policy
- The consensus has been bearish, yet bond returns have been stable

### Summary

Three months ago, in *Coming to America* we highlighted that value had begun to build in US Treasuries – and would soon arrive. This followed the rapid cheapening in Q1 amid outsized US fiscal announcements, the DM growth recovery, reopening and investor confirmation bias as inflation base effects kicked in.

Before going long real yields from a fundamental perspective, however, we explained that the Fed would first need to announce their widely anticipated tapering policy. Having taken profits on our US Treasury short several weeks ago, we find, three months on, that we are still having to wait for the Fed to get round to moving into

the next policy phase, even though 2021 is still on track to be the strongest year for US growth in at least 36 years! The upshot has been a quarter of Fed procrastination, even though the BoE and BoC have got on with the job and announced tapering of their own purchases. For the Fed, by contrast, we think the ghost of 2013 looms large, making them adopt an overly cautious stance.

### Outlook

For professional investors  
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Nevertheless, we must respect that their new FAIT framework means this will be a gradual process, unless the data or markets force their hand. This has left rates markets essentially on pause in Q2, joining what had already become sideways price action in credit, after the drama of 2020. Sometimes markets sprint (H1 2020 across fixed income, January and February in US Treasuries) and sometimes they crawl. Most of fixed income has crawled since March. Still, the lesson from such prior episodes – summer 2014 and H2 2017 spring to mind – is that, eventually, policy eases off and volatility returns. So, we are mindful that getting sucked into carry trades or expecting low rates volatility from here on are more likely to be dangerous assumptions than not.

In duration, we think market participants have become too short on those curves globally that are too steep, wielding secular inflation regime arguments that are, for now, too specious. Some have positively hyperventilated about inflation. Yet much of what has occurred was known a year ago. Front-end oil contracts fell from USD 70 pre-Covid to below USD 0 and back up to USD 70 again, yet we take a different view to the consensus as to which one of those numbers is more remarkable. The consensus is fixated on a 5% headline CPI, in year-on-year terms. Airline and travel inflation in early summer 2021, when compared to activity which was essentially de minimis last year, tells us little. The level-versus-flow distinction we discussed last year remains relevant. Moreover, the trouble with expectations is that when they are already hyped up, it is harder to achieve right-hand tail surprise outcomes.

Meanwhile central banks have taken the ‘transient’ view on current inflation dynamics, resulting in a Fed and ECB on pause. For those in bearish duration positions in steep fixed income curves with negative carry and finite patience, the recent outcome has been clear: capitulation.

To be clear, we think the lower yields in recent weeks are market related rather than a fundamental move – fully understandable given the lopsided nature of bearish investor positioning in fixed income and the ferocity of moves earlier in the year. We also view prospects to make money through shorting duration quite differently in different markets. We think curve slope, not absolute yield, is a more important valuation metric to watch. That means looking for short opportunities in Gilts and the EUR 2s5s curve, where there is comparative flatness, at least versus the US and dollar-bloc curves at present. While many people like to focus on 10-year US Treasuries when they discuss or take active views on fixed income, we think the opportunities will require a bit more imagination and

a more global perspective. We continue to believe cross-market and curve trades have higher information ratios than directional duration positions and we suspect developments in Q2 may make others begin to think more along those lines too.

In credit, we think IG and HY markets, at their tightest levels since Q2 2007, look pretty much as good as it gets. While both rates and credit have been somewhat directionless for the past three months, we think rates will continue to provide the better active opportunities, and don’t foresee huge movements in credit – certainly not on the tightening side. As we said in December 2020, the outlook for credit in 2021 is either boring or bearish.

Heading into H2, we still find plenty to disagree with in the prevailing market consensus. The 2021 dollar weakening trade continues to look suspect, and many of the secular inflation regime arguments look poorly constructed. The bearish fixed income consensus also seems to overlook rates market dynamics hidden behind nominal spot curves: we think breakevens tend to narrow during periods of central bank tapering; and we note 5y5y forwards tend to peak in the calendar year after recessions. Taken together, these points mean care will be needed as the Fed and ECB address the outlook for QE and PEPP into Jackson Hole and the September meeting, respectively. It also implies that prevailing consensus market trades might struggle, which in turn ought to provide opportunities. We may not have a sprint in markets in Q3, but a crawl is unlikely to last forever.

# Contents

Macroeconomic and policy outlook.... 4

Rates strategy..... 8

Fixed Income asset allocation.....10

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# Macroeconomic and policy outlook

The outlook for the global economy has brightened further.

## Growth outlook: seeing the forest for the trees

The outlook for the global economy has brightened further. Vaccination progress has helped drive down hospitalization rates in particular, and allowed for a (strong, albeit not full) reopening of many economies.

The threat of virus mutations, as yet undiscovered new strains, and the lag in vaccinations across EM, means it seems premature to extrapolate a persistent return to full global reopening; the recent, renewed restrictions in some Asian countries are a case in point. Still, the strong rebound in services activity and favorable base-effect comparisons imply spectacular QOQ and YoY growth rates in Q2, especially in DM. The challenge is that much of this was anticipated by growth forecasts from several months ago, and from upbeat surveys which reached heady levels back in the spring.

At the same time, supply chain disruptions – in part still pandemic related – cloud the picture, while seemingly giving a boost to inventory demand and hence bringing forward future manufacturing production. The specific nature of the virus downturn and the corresponding unfolding of events on the way back up mean this is not just a straightforward nominal GDP recovery.

## 'This is not just a straightforward nominal GDP recovery'

This all makes it challenging to see the forest for the trees, because while the *contour* of this year's growth recovery after last year's growth drawdowns is clear, distilling the *underlying longer-term global growth trend* is less so.

Into H2 2021 and beyond, it seems sensible to discount some further (services sector) reopening effect, eventually spreading to EM. In the near term, the impulses from the earlier sizable monetary and fiscal support should help to keep economic growth above trend.

Pent-up consumer demand will help as well, although we are not holding our breath<sup>1</sup> as the savings surplus is

skewed to higher income cohorts with a lower marginal propensity to consume, and precautionary saving tendencies of lower-income cohorts will likely remain above pre-pandemic levels for quite some time to come. Recall last cycle that many cyclically oriented economists expected consumer and corporate cash piles to be unlocked and spent post-2008, only for those hopes to be dashed by more secular drivers, as foreshadowed in Japan post-1990. The lesson is that shocks can change behavior.

Into 2022 – and aside from left-hand tail risks on new virus problems (where we remain humble as to our ability to make predictions) – we think it will be increasingly challenging for growth to stay above trend.

How policy help evolves will be key. The measure we track in China to gauge the combined impulse from monetary and fiscal policy to future growth – the credit impulse – has turned clearly negative. This has tended to be associated with noticeably slower demand growth some 6-9 months later.

In the US, the combined fiscal and private-sector credit impulse is still holding up well into 2H, despite a slowdown in mortgage demand. The same applies to the Eurozone, where a lot of money from the EU's recovery initiative will start to flow. But the overall credit impulse for the US and Eurozone will probably follow that of China into negative territory in 2022 – as the sheer magnitude of fiscal support this year cannot be maintained (even with a forthcoming US infrastructure plan).

All this means that manufacturing growth in particular will likely start to lose steam later this year. This in turn could come to challenge the bullish commodities backdrop.

## Inflation hyperventilation, continuing debate

As with economic growth, the contour of inflation into Q3 is clear, but gauging the underlying trend in inflation is perhaps less so. One way to frame the outlook is to divide up the horizons into tactical, cyclical and secular.

The proximate causes of the recent rise in CPI prints are clear: supply chain disruptions, sometimes combined with pandemic-related behavioral shifts (as in used car prices, for example). Post-reopening price discovery in services –

<sup>1</sup>We note that a recent [report by the European Commission](#) indeed concluded recently that pent-up consumer demand in the EU would likely be limited

compared to essentially non-existent activity last year (in airfares and lodging, for instance) are next.

Both these trends amplify the base-effect-led rise in headline inflation rates that we pointed to six months ago and which will continue to drive the near-term outlook. This remains a story of “two camels”, with a single hump in the current US CPI profile (rather like an Arabian camel) owing to energy base effects, versus two humps in the Eurozone headline inflation trajectory (more like a Bactrian camel), with the additional effect of the re-weighting of HICP items and German VAT base effects.

Hyperventilation in the media and bond bearish commentary about the recent 5% headline CPI number, overlook the reality that USD 70 oil is historically unexceptional – unless of course you compare it with the economic wasteland of Q2 2020. Elsewhere, rollercoaster prices in commodities such as lumber (which almost gives Bitcoin a run for its money for volatility) suggests the recovery in underlying demand, and robust housing sector, is not the only driver of financial market futures. There is an evident circularity in financial market participants pushing up commodity futures prices only for other financial market participants to suggest they portend higher future real economic demand. We would be less quick to rush to such judgements. On the other hand, food prices are rising, which could prove especially challenging for some EMs, where food prices still entail a much bigger weight of the overall consumer price index than in DM.

Yet, it should be emphasized that all of these drivers are proximate and, to varying degrees, were known about between 3 and 6 months ago. While semiconductor-based shortages could persist into 2022, the Fed and ECB may indeed be correct to judge most of these other influences as transitory. Will airfares be rising at the same year-on-year rate one year from now?

On the cyclical outlook, labor market mismatches and lingering supply constraints due to the pandemic (generous government support or lack of childcare, depending on your socio-political perspective) have boosted expectations for US wage growth. Yet from our bottom-up analysts’ surveillance, wage rises are isolated so far to one or two sectors. Fear of the virus may also be a genuine factor in slowing the return to workplaces: the current supply of labor may not in fact equate to those in the U6 data available to work, but rather to some smaller number adjusted for willingness to return amid a lethal pandemic which has not yet disappeared. Should we see a scenario in H2 of completion of vaccinations across adult populations, diminishing fears of the virus, full

reopening of schools, falling unemployment benefits and depleted savings for lower-income earners, one could even see an acceleration in job gains at the same time as falling wages, as both the demand and real-world underlying supply of labor rise. Overlaying a textbook labor market recovery onto this cycle could result in disappointment. We must remind ourselves we live in unusual times.

On the secular horizon, we count at least nine fashionable arguments for higher inflation among the consensus. Yet we find many of them either poorly evidenced, optimistic or unproven. There is no space in a quarterly outlook to explore the full topic in depth ([please see our earlier podcast on inflation](#)), but given its centrality to the bond outlook, let’s summarize some of the key ones.

First, central bank money supply has had more effect historically on asset price inflation (API, if you will) than CPI. Second, high prevailing debt in DM has historically resulted more often in low inflation and low interest rates, and not the converse (calls to inflate it away are aspirational and, due to the effect of refinancing coupon rates on debt sustainability dynamics, illusory). Third, ageing DM demographics have become a popular argument for higher inflation, even though they have never in history caused inflation in any economy. Next, 1960s secular inflation comparisons fall short on the private sector credit creation of the boomer generation, which is going into reverse today: the latest Fed Z1 data shows that while US mortgage growth is robust, consumer credit is growing at less than 3% and corporate debt at less than 2% annualized – a contraction in real terms. Fifth, fears of a shortage of cheap EM-based manufacturing labor contradict the latest UN population projections: specifically, the fears overlook forward supply of 1bn people and are therefore at least a decade early, because of ongoing rural-urban migration in EM and the fact the global unit labor cost arbitrage story is not just about China. Sixth, the polarization of the globalization debate overlooks *re-globalisation* as rising countries (e.g., Vietnam and India) gain more emphasis in the western economic and geopolitical orbit. The relationship between US and China could change substantially, but healthy global trade flows suggest the US and European relationships with many of the other 193 economies on the planet are alive and well. Under Biden, multilateral relations are becoming more institutional again and less unpredictable after the Trump years. Reshoring looks set to be highly specific to a few strategically sensitive industries (think multiyear semiconductor capex plans, fill and finish vaccine vials, artificial intelligence, etc.). The pandemic may change many things, but we think the laws of comparative advantage, which have been discussed in

the literature for over two hundred years, are not one of them. Some commentators have even pointed to queues of container ships at ports as simultaneously also indicative of higher inflation. Yet if queues of container ships are evidence of booming international trade, how does that square with deglobalization!? And so it goes on.

But just because there are so many poorly put together arguments for a secular inflation breakout does not mean that other drivers won't come to the fore. It is better to be humble about where the unknowns lie rather than make rash judgements prematurely. We do not yet know the full lagged impact of US fiscal drivers on inflation, for example. Similarly, the ability of semiconductors to provide a supply shock in the digital age (just as oil did nearly a half century ago) should be respected. Might today's Fed and ECB have described the 1973 oil rise as transient?

**'Just because there are so many poorly put together arguments for a secular inflation breakout does not mean that other drivers won't come to the fore'**

On the other side of the ledger, we still see secular forces, notably, ageing DM demographics, automation and technology, keeping a lid on wage and inflation pressures, factors that were continually underestimated through the period from the mid-1990s to 2019. It is highly unfashionable to mention these themes, yet we don't think they've gone anywhere!

As for inflation-linked bond markets, although lingering inflation uncertainty might support risk premia in breakeven inflation rates, the stretched long positioning and already-rich valuations, certainly in front-end UK, EUR and the US, pose a risk of a repricing. This would be particularly relevant if a QE taper tantrum – which central banks so far have managed to avoid – would emerge after all.

We believe the inflation debate will not be settled over the next 2-3 months, as the tactical factors we described still exert an influence. Over the longer run, we find it easier to debunk some of the poorly evidenced arguments we encounter, but we think it is more prudent to retain an open mind on the fiscal and labor market dynamics. And in any case, for all our hours debating inflation internally across functions, for some markets such as the Schatz-OBL

spread, asymmetric valuations mean the conclusion may not matter anyway!

### **Policy outlook: QE taper – it's the arrival date, not the journey**

The crafty coordination between fiscal policy and monetary policy remains ongoing, with sizable fiscal deficits still being funded to a large extent – varying across countries – by ongoing expansion of the central bank's balance sheets.

In the US, thanks to the USD 1.9trn Covid relief bill, the fiscal stimulus unleashed this year has managed to exceed last year's impressive injection, keeping the fiscal *impulse* (i.e., the change in the fiscal stance compared to last year) to economic growth in positive territory. Into 2022, it will be hard to keep it there, even if the forthcoming infrastructure plan surprises on the upside.

In the Eurozone, the latest estimates from the European Commission show that, as some of the fiscal support was not spent last year, the fiscal impulse in 2021 will also remain positive. And if we factor in the support via the 'Next Generation EU' recovery fund that will start to flow meaningfully in the second half of the year, it is clear that fiscal policy remains a tailwind to economic growth. This applies especially for the countries in Southern and Eastern Europe receiving most of the grants. The flip side, as in the US, is that this will be unlikely to be sustained in 2022. Notably, the fiscal impulse in China has already relapsed into negative territory.

On the monetary side, with the growth rebound in full swing, especially in the US, talk about a tapering of sovereign bond purchases is a matter of when, not if. The BoE and BoC have already announced – and begun to implement – a further trimming of the pace of net purchases, albeit refraining from committing to a fixed end date.

While the Fed has pledged to wind down its corporate bond portfolio by year end, it is treading more carefully in its sovereign and MBS purchases, keen to avoid the taper tantrum of 2013. But at least the Fed has signaled it will start talking about tapering these asset purchases – likely as soon as the 16 June meeting. The official announcement might still be timed for September-October, and there is the opportunity of Jackson Hole trial balloons in the meantime.

Our take from the 2013 episode is that it was the sudden nature of the taper hint from Chair Bernanke that

prompted the sharp market reassessment. Notably, this worked to raise term premia and brought forward investors' expected date of rate lift-off – Fed rate hike expectations two years out rose 100bps during the May to September 2013 period. Hence, we believe the length of the taper process may be more important than the amount of net QE still hitting the market in the interim, with the risk that it could be shortened if inflation proves less transitory than the Fed currently opines. Moreover, we remain of the view that real yields are more vulnerable to upward pressure in a taper than nominal yields. Indeed, it was notable that the recent FOMC minutes caused a 20bps downward correction in breakevens, overriding the two higher CPI numbers. That is entirely fair in our view: QE is a reflationary policy, and tapering is a critical step towards ending it.

**'The length of the taper process may be more important than the amount of net QE still hitting the market in the interim'**

In the Eurozone, the ECB is still of the view that it is premature to talk about a QE exit, and expects to keep the monthly purchase pace under its emergency QE program PEPP in Q3 (as in Q2) "significantly" above that seen during the first months of this year. And beware that even if the PEPP program will be phased out by mid-2022, as seems a plausible assumption, the 'regular' APP program will still be running at a pace of at least EUR 20bn per month during the remainder of 2022. It is notable that in the past 6.5 years, the ECB has only been able to operate without net bond purchases, under the guise of one acronym or another, for a grand total of 9 months. While markets have hyperventilated over inflation, the 2014 ECB regime shift has arguably been much more powerful and persistent for fixed income markets, and we have high conviction that it will remain part of the future.

Meanwhile in China, where PBoC balance sheet expansion has been much more limited, also in comparison with 2015/2016, we expect the balancing act between supporting growth, slowing leverage, and containing debt-cleansing spillovers to remain in place.

### **Policy rates: still in early-stage normalization**

We still think G-10 central banks will be inclined to follow the Fed's normalization blueprint of 2013-2015, with the

onset of interest rate increases coming after balance sheet expansion has ended. The precedent of the last cycle, and confirmatory remarks from central bankers, now gives a more established roadmap on sequencing. Rate hikes in the next 12 months therefore still seem confined to early movers such as Norges bank – where sovereign QE has not been taking place. Looking further out, it will be the persistence of the current rise in inflation rates that will decide the timing and pace of rate normalization.

For the Fed's trajectory of tapering and rates liftoff, we expect a tapering announcement towards the end of the summer. The actual process could then start in 2022 and take until December of that year. That would point to Q2 2023 as the earliest realistic date for a first rate hike. The whole process could be quicker, but for that we would probably need evidence of accelerating (wage) inflation. The Fed have been clear with their FAIT framework, (announced less than a year ago), that averaging inflation rates means a de facto slower response than in prior cycles, all else equal. It's worth recalling that amid all the international crises of 2011-15, there was a seven-year gap in the last cycle between the Fed's last cut in 2008 to its first hike.

In the Eurozone, the ECB is still trying to keep the possibility of a further rate cut alive, although markets assign only a minor probability to such an outcome and discount 5-10bps of tightening in two years' time. (If they didn't manage to cut in the biggest economic shock in seven decades, what precisely would it take to provoke a cut from here?) We see risks as skewed to the ECB being on hold for longer, but as it will take some time before it becomes clear if higher inflation is indeed transitory (as seems the ECB's base case), we think that markets could price in more rate tightening in coming months rather than less. Still, we see a chance that the ECB uses the outcome of its strategy review later this year – after which they likely announce the shift to a symmetric 2% target – to strengthen its forward guidance to dampen/control policy rate hike expectations. This means the scope of market move that the ECB may allow here is modest.

Meanwhile, in EM, pressure on central banks to follow the lead of those of Brazil and Turkey earlier this year, should intensify as higher food and energy prices look set to seriously lift EM headline inflation rates.

In China, despite the PBoC's modest tightening bias, actual policy rate hikes do not seem imminent, given subdued underlying inflation pressures and debt-cleansing spillover risks in the local government, property and financial sectors.

# Rates strategy

Market participants have been scratching their heads at why 5% inflation and 10% annualized quarterly growth is not leading to higher yields.

## Fed procrastination, duration capitulation

Market participants have been scratching their heads at why 5% inflation and 10% annualized quarterly growth is not leading to higher yields. Earlier in 2021, the narrative seemed to be lining up: economies reopening, trillion-dollar US infrastructure plans, uncertainties about tapering, etc. Indeed, the three-month period from the January Georgia elections, via the poorly received 7-year Treasury auction in late February to the announcement of the American Jobs Plan in late March, saw an acceleration higher in yields. Yet markets have been more or less rangebound ever since, with the recent market capitulation seeing the 10-year now no higher than its level of 24 February. So, what's going on?

## 'A vast majority of investors are short US duration versus their benchmarks'

We think the answer lies in positioning. It is quite clear, from our own proprietary regression analyses, painstaking in-house collation of publicly available data and external surveys, that a vast majority of investors are short US duration versus their benchmarks. A similar but smaller bias is visible in Bunds. While futures positioning seems to suggest a recent shift in faster players, the latest available data for the largest real money managers still points to an overwhelming short consensus. Further, the 5.0% May US CPI print was a good test and, rather like the response to the >10% m/m March retail sales headline (when Treasury yields gapped lower), shows the near-term pain trade remains for lower yields.

Now, it is true that much of the market was also short rates in Q1, when yields rose. But the breadth of the shorts became even more extended in Q2. Our own analysis suggests that 90% of the largest US managers are already short duration. Logically, if we accept that large market movements are ordinarily driven by surprises, it would appear that a further selloff in US Treasuries would only be a surprise to around one tenth of the market. The prevailing investment narrative has focused on post-vaccination GDP recovery, higher year-on-year prices, expectations of Fed tapering, larger-than-2009 fiscal stimulus, or (that favorite of the past 12 years)

optically low absolute yield levels. Yet the challenge with all of these components of the current fashionable short duration investment thesis, is that none of them are unique insights. Who is not aware of vaccine progress, base effects, the taper debate, the fiscal size or the level of yields?

We do not believe markets are perfectly efficient. But we do believe there is a sliding scale of market efficiency whereby anticipated trends based on the latest available data and information are priced in pretty quickly into the deepest and most liquid markets. As a result, the creation of 2,158,000 net new US jobs in the last four months has not been enough for yields to rise above the forwards, because the market already expected that outcome (and some expected even more). Similarly, while the Fed are now talking about talking about tapering [sic], they have not yet, as of the time of writing, announced it. The pace of the process has been sufficiently glacial, controlled and managed (see the [Central Bank Watcher](#)), such that there has been no room for a 2013 (let alone 1994) type surprise. What is already known is already in the price. For yields to rise – and they must rise beyond the forwards for shorts to make money – something new, and by definition something not currently expected, needs to happen. (Needless to say, the unexpected newsflow needs to be right tail in nature rather than left tail....)

That does not mean that a further selloff in Treasury yields in 2021 is an impossible scenario. But it does mean that *the bar for the data is that bit higher*: inflation and/or job gains – and in response the Fed reaction function – need to overshoot by that much more in order to generate a sell off. The prevailing narrative is not enough.

Then there are supply fears. While issuance can be an important factor for specific market segments (e.g., SSA paper, or long-end BTPs), we don't see this as a distinguishing factor for the direction of global rates for now. Dealers were regularly ringing the alarm bell on the take up of bond auctions earlier this year, but this has no longer been an issue recently. Indeed, the 10-year auction in early June was positively robust. There might even be some positive news on issuance coming, as the US Treasury could well announce a reduction in coupon auctions later this year.

On valuations we also think the consensus bearish view isn't well constructed. Too many investors in our opinion

(often asset allocators) focus on absolute yields. Frequently, we hear the observation that nominal yields are lower than at many times in history. This has always struck us as an odd investment thesis: you cannot go short today's yields and long those of ten, twenty or thirty years ago. One can only go long or short today's market and choose today's alternatives such as cash (which right now yields -3 to -5% in real terms, depending on your measure).

By contrast, we think curve slope is overlooked. Steepness matters particularly for large institutional investors, such as currency-hedged Asian private sector institutions (where the FX hedge means the slope from full maturity yields to 3mo is what matters), or domestic floating rate funders, with significant liquidity requirements post-2008, such as financial institutions. Indeed, on cross-border demand, the TIC data has pointed to international investors switching from net UST sellers to net buyers given the comparatively higher yields available over 3mo rates in the US. In the past we have seen cross-border demand being triggered by relative valuation. In this context, the steepness of yield curves is more important than yields levels, as the curve incorporates a large part of cross-currency financing costs.

## 'Yield curve steepness matters particularly for large institutional investors and domestic floating rate funders'

Separately, many pension funds are incentivized to care more about funding ratios, rather than active views on valuation. In many cases, that means locking in the best surplus position in over a decade – and receiving rates.

The power of all three of the above investor types is being underestimated in our view – even though they are structurally among the largest institutional market drivers away from the official sector.

Within the global rates spectrum, three government bond curves stand out as being steep: the US, Australia and New Zealand. This means, generally speaking, that the difference between forwards and spot rates will be higher in these markets and that they will be more attractive from a foreign investor's perspective.

A return to first principles may be helpful here. To investigate the chances of yields 'beating' the forwards when curves are steep, we have looked at 3m-10yr US

curve steepness data since 2000. For this timeframe we plotted steepness against the realized 10-year yield versus its 12-month forward one year earlier. This exercise shows that there is a large hurdle for US yields to rise above their forwards when the 3m-10yr curve reaches a steepness of 2.0%. Over a twelve-month window, this happened in only 5 out of the 81 months with >2% curve steepness, versus 25% for the whole sample. Australia recently came close to this 2% level for 3m-10yr and now corrected back to 1.45%. The US curve was not at 2% yet, with a peak of 1.54 and current 3m-10yr steepness of 1.31. New Zealand is at similar levels.

## So where are we positioned?

Looking at relative curve steepness versus the potential for yields to rise on the back of central bank policy normalization, for now we see the best short duration opportunity in the UK. For longs, we prefer China, given the fundamental and policy backdrop outlined earlier, and the steep curve of New Zealand. In the US we have refrained from outright duration positions beyond 2yr maturities for a while now, having taken profits on short positions earlier in Q2. We would look for a further positioning washout and more compelling entry points before establishing new shorts, for example in 30-year Treasuries versus Bunds. On a longer-term horizon, new fundamental triggers for higher yields could come from wage growth and possibly ill communication around tapering after the summer, but we think the Fed are self-aware of the risks on the latter. In Germany we think it will remain difficult for 10-year yields to durably break the -0.05% level, but 2-5 steepener positions look increasingly attractive again at levels below 5bps. Finally, in Japan, we remain underweight.

# Fixed Income asset allocation

In spread products, it seems little has changed since last quarter. We are still in the very first year of a new economic expansion but the ninth year of all-time highs in the S&P500.

## Early-cycle fundamentals, late-cycle valuations

In spread products, it seems little has changed since last quarter. We are still in the very first year of a new economic expansion but the ninth year of all-time highs in the S&P500. Economic and market cycles are usually much more aligned. The upshot is that from a cyclical perspective, the fundamentals almost couldn't be better (the Eurozone is in its very first quarter of a new expansion in Q2 2021, for example), but market risks (valuations, excess froth in other markets) look late cycle.

Fed procrastination has allowed carry trades to continue. Yet with US High Yield at an OAS of +321 (the tightest since July 2007) and IG at an OAS of +90 (the tightest since March 2007) we see little to play for from here. Our stance is therefore unchanged. We recognize that out of a binary choice of being invested in credit, or not being invested over the last several months, it has been marginally more profitable to be in the market. Yet, USD IG spreads have tightened just 4bps since the end of February – barely more than bid/ask. On the surface, HY has done better, with spreads tightening 35bps, however much of that has been driven by the energy sector, where spreads are nearly 100bps tighter over the same timeframe. The US BB-B index Ex-Energy and Utilities is actually wider now (at +270) than in early April (after reaching a tight of +261).

**'For spreads to tighten from here, one of two things must happen. Either default premia or liquidity premia must fall further'**

For spreads to tighten from here, one of two things must happen. Either default premia or liquidity premia must fall further. The former has probably run most of its course (even if there is a potential small amount to go in energy). The latter, too, is already at post-2008 tights. For spreads to make progress from the tightest level reached post-2008 (+316 in 2018, which is a rounding error away from today's level) to the tightest level pre-2008 (+241 reached in June 2007), we would presumably need a return of 2004-07 structural market drivers. A pre-2008-

style unregulated banking sector seems virtually impossible. A structured credit boom across the ratings spectrum seems similarly unlikely. Still, in leveraged loans, higher CLO volumes are possible (a Fed on hold for a long period would create the conditions for carry, a bearish duration investor base would create the demand for floating rates), but the overall balance of probabilities suggests playing for a tightening to two-decade tights in HY at a pre-2008 +241 isn't great risk-reward, at least for an aggregate portfolio context.

The current market narrative is that carry trades should continue given the recent fall in nominal Treasury yields. However, even though we do not expect the Fed to drop the ball on market communication, the simple fact is that Fed taper events are still ahead of us. We continue to adopt the framework that QE is reflationary and tapering (the obverse of QE) has a reversal effect. No one has described the process of tapering on markets better, in our view, than James Bullard. At a lunch in 2013, the St Louis Fed President laid out the thesis that QE makes the following five things happen: real yields fall (because the central bank is buying), inflation breakevens widen (because QE is reflationary), the currency falls (because the number of dollars, all else equal, increases), equity markets go higher and credit spreads go tighter. Tapering is simply the reverse. The silver lining is that the market effect of both tapering, and the anticipation of tapering, has been less severe than the beneficial market impact of QE. This has much to do with starting valuations (QE announcements are usually made when bad things are happening and credit spreads are wide), but it is also because tapering is a tactical policy-led market event, rather than a cyclical cause of bear market such as a recession. USD IG has returned excess returns of slightly less than zero in taper and post-QE periods, versus 0.75% per month in QE periods.

The challenge is that while the end of easy policy phases in the last cycle may not have caused much domestic market drama in the US, they certainly precipitated problems in other parts of the world. Within months of the end of LSAP1 we had the first Greek crisis. Almost immediately after the end of LSAP2, in June 2011, the BTP market lost its footing, and the Bernanke May taper speech unleashed what ultimately became 2.5 years of turmoil in emerging markets. So, while the Fed may be

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very gradual and careful in their communication for the remainder of this year, what chance that disruptions could be awaiting in a dollar-reliant corner of the world with high debt levels? Chinese private sector, weaker SoE and local government debt might be one to watch.

All in, we prefer to maintain our cross-market overweight in EUR IG versus USD IG. The lower duration of EUR IG, the lower level of Bund volatility, and the fact that when PEPP eventually stops (presumably sometime next year), APP and CSPP are likely to still be in place, means that the direct ECB support for the corporate bond market will remain superior to that in the US. We came up with the phrase 'under the umbrella' two years ago to describe the comparative shelter that the EUR IG market enjoys relative to global peers (see '[The Night Shadows: Investing in fixed income if recession hits](#)'). In particular, while future performance may not be superior in EUR IG, we continue to believe its ex ante Sortino ratio (a measure of downside risk avoidance) will continue to provide superior risk-adjusted portfolio construction. This strategy worked spectacularly well in March 2020 (when USD IG dramatically underperformed EUR IG). We think more modest outperformance is possible should USD IG spreads become dislodged from their tights in H2.

## 'Credit curve strategy in our view is highly valuation dependent'

Given the benign default outlook, we prefer to focus on notional risk (we are happy to run a higher-than-normal MV%). However, given our analysis of valuations, we prefer to run an underweight CTSD. This means a focus on the front end of credit curves, where again risk-reward should be better. This is a big contrast to our strategy in late March and Q2 2020, when we favored the long end. Credit curve strategy in our view is highly valuation dependent.

### Eurozone periphery: more conservative in BTPs

Heading into Q3, we adopt a more cautious stance towards country spreads, given valuations and longer-term political factors. Even as the ECB is maintaining a higher purchase pace over the summer, the PEPP taper story is expected to get back into focus again as Q3 progresses. Growth and inflation in the Eurozone continue to move in the ECB's desired direction, and a reduction in PEPP purchases could hence be announced at the ECB September meeting.

Moreover, at our quarterly discussions, one of our guest speakers indicated that, in their central scenario, PM Mario Draghi is expected to succeed President Sergio Mattarella early next year. Should this scenario unfold, the question of Mr. Draghi's succession would materially increase political uncertainty. It's possible that early elections could be announced, which are otherwise not scheduled before 2023. Should the market start pricing in such a scenario, volatility in BTPs would likely surge, so we have adopted a somewhat more defensive positioning in BTPs. In addition, a 5s30s BTP curve flattener could be implemented should uncertainty around the position of Mr. Draghi indeed increase. The BTP curve tends to flatten materially through Italian political volatility.

In France, as in Italy, spreads have widened and then re-tightened over the past three months. It seems premature for markets to worry at this stage about next year's French Presidential elections, even if there are now only ten months to go. Nevertheless, given events in 2017, some caution is warranted from Q4 onwards should spreads remain as narrow as at present and should President Macron's poll ratings linger at current levels. We note Macron has sought to protect his right flank from Mme Le Pen over recent quarters. Should this pattern continue, it may show up in markets in other areas, for example in renewed tensions with the UK, which may provide opportunities to increase Gilt shorts.

Elsewhere, we retain our market-weight position in Spain and are relatively constructive in EU and AAA positions to offset spread underweights elsewhere.

### EM debt: continued underweight

Given valuations and fundamentals, we continue to be moderately underweight EM risk both in sovereigns and credit. Whilst EM countries have weathered the pandemic better than the worst feared last year, divergences in vaccinations rate, case trends and re-opening momentum remain higher in developed countries compared to the emerging world. Asia was an exception, given its superior pandemic management especially last year, but the last three months have seen bouts of virus case increases and local lockdowns as travel/mobility improves, as experienced in Thailand, for example. The strength in commodities and risk sentiment has provided a more positive market backdrop with continued EM sovereign and credit issuance and fund flows. However, EM central banks have shifted from being majority easing last year to a more hiking/hawkish tilt the past several months. This shift has been driven by higher growth and inflation

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dynamics, with surprise hikes from Turkey, Russia and Brazil. The rise in food costs, particularly in the likes of corn, have brought inflationary risks into focus in certain countries. The escalation in political uncertainty such as in parts of Latin America will dampen domestic demand and foreign investment.

**'With Fed taper discussion in focus, concerns with EM vulnerabilities have increased. The range-bound trading in US Treasuries after the first quarter sell-off and cleaner EM risk positioning among fund managers, has provided a breather to these risks'**

With Fed taper discussion in focus, concerns with EM vulnerabilities have increased. The range-bound trading in US Treasuries after the first quarter sell-off and cleaner EM risk positioning among fund managers, has provided a breather to these risks. As mentioned last quarter, the current account dynamics are in general now quite different from 2013. Some EMs have seen sizeable improvements in their current account through their trade balance channel, which limits them from external funding fragility. Other countries have accumulated sizeable public debt, while their growth profile has been lagging. More vulnerable examples are South Africa and Brazil. Given the steady grind tighter in EM sovereign spreads, valuations for the asset class remains unattractive. In China, recent default concerns at Huarong's offshore issuing entities and spread volatility at Evergrande has widened hard-currency Asia IG and HY spreads, and provided profitable trading opportunities for us in the iTraxx Asia ex Japan index, but we have not yet seen material spillovers to other markets.

There still are positive real yields available in countries such as Indonesia and Mexico, but these provide only modest compensation for potential FX depreciation and increasing volatility. We have increased our OW duration position in Chinese government bonds with the expectation that, as the corporate defaults cycle continues, the PBoC will manage bond yields in the near-term. The evolving relationship between the US and China bears watching. Many of former President Trump's policies have been continued by President Biden and, as time progresses, an almost inevitable question looms over the etiology of the Covid-19 virus and relative US and Chinese governmental views on how the early stages of

the crisis were handled. This has the potential to prove highly material to long-term geopolitical and economic relationships. Watch this space.

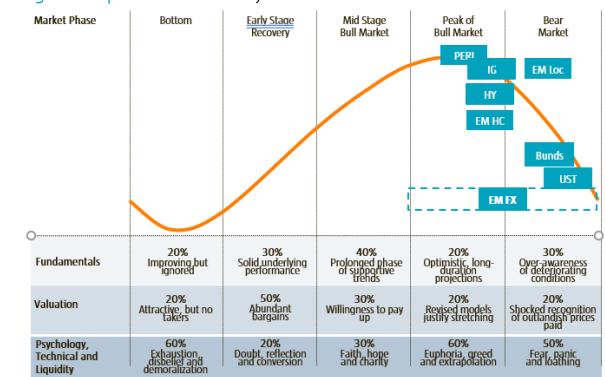
## FX: USD to consolidate, divergence among EMs

The great dollar weakening of 2021, as predicted by the consensus, hasn't really occurred. The dollar has actually appreciated slightly against the euro since 1 Jan, is unchanged against the likes of the Australian dollar and Mexican peso, and is meaningfully stronger against the yen. Still, EMFX has been resilient in Q2.

From here, further broad-based gains in cyclical and EM FX will have to wait, in our view, as multiple speed bumps likely limit gains and trigger divergence. With few notable exceptions, including the JPY, the stronger US economic recovery has had a limited effect on Asian and cyclical G10 FX, given the increase in risks, globally, of policy normalization and higher inflation. The multi-speed recoveries around the globe are now facing risks from a resurgence in Covid-19 infections (see Asian region) and mobility restrictions. In addition, attention has shifted to the moderation in China's fiscal/credit impulse. Inflation concerns have risen, partly on higher commodity prices, adding to concerns of premature policy normalization. Higher commodity prices also adversely affect many EM's current account balances. Finally, foreign portfolio flows remain selective, contributing to unexpected headwinds for some currencies.

## Asset class positioning

Figure 1 | The market cycle



Source: Robeco, June 2021, Morgan Stanley cycle characterization

Source: Robeco, June 2021

We expect the USD broadly to consolidate over the medium term, as valuations limit its ability to gain despite likely outperformance by both US growth and asset

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markets. We expect the USD to gain against other G10 safehaven currencies, but to weaken against commodity G10 and GBP. Against EMs we expect the dollar to show a mixed performance, depending on the country. However, we cannot ignore risks of a broad-based USD bounce as more tapering commentary from Fed speakers likely would reduce the downward pressure on the USD.

This broad USD narrative has important implications for EM and cyclical FX. Global central banks will try to iron out policy withdrawal as much as they can, hence the current benign environment for EM and cyclical FX, but the risk remains of anything on the tantrum spectrum taking a bite out of these currencies, if prior playbooks from previous episodes are anything to go by. The script suggests that these currencies will suffer initially, but

could be hit much harder one year after those events. This is as financing conditions could turn materially worse, in combination with reduced global growth as stimulus is taken away. Overall, we remain very conservative in our FX positioning. By having a small underweight in ZAR vs MXN, we are playing this country-divergence theme where fundamentals of South Africa clearly are much worse than those of Mexico.

*We wish to thank Francis Yared (Deutsche Bank), Christoph Rieger & Michael Leister (Commerzbank), Christian Schulz, Aman Bansal & Jussi Harju (Citi) and Min Dai (Morgan Stanley) for contributing to a productive and insightful quarterly outlook session.*

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