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The 2021 Fixed Income Outlook
Where to Look, What to Do

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- Rates will be lower, and yield curves flatter, for longer. Investors must deal with this reality and plan for optimizing their portfolios accordingly.
- If you need return, you need to look outside Developed Market Government Bonds. Emerging Market, especially China, and High Yield bonds are the key places to consider.
- Credit will be supported by central banks worldwide. We believe that will sustain spread products for some time.

Lower, Flatter Persists

The first point we need to make is that we think the interest rate environment we are now in is going to persist for a while. In the words of the song – 'Now is Tomorrow' and investors need to optimize for now. Lower rates and flatter yield curves are no blip.

What's Wrong with Developed Market Government Bonds?

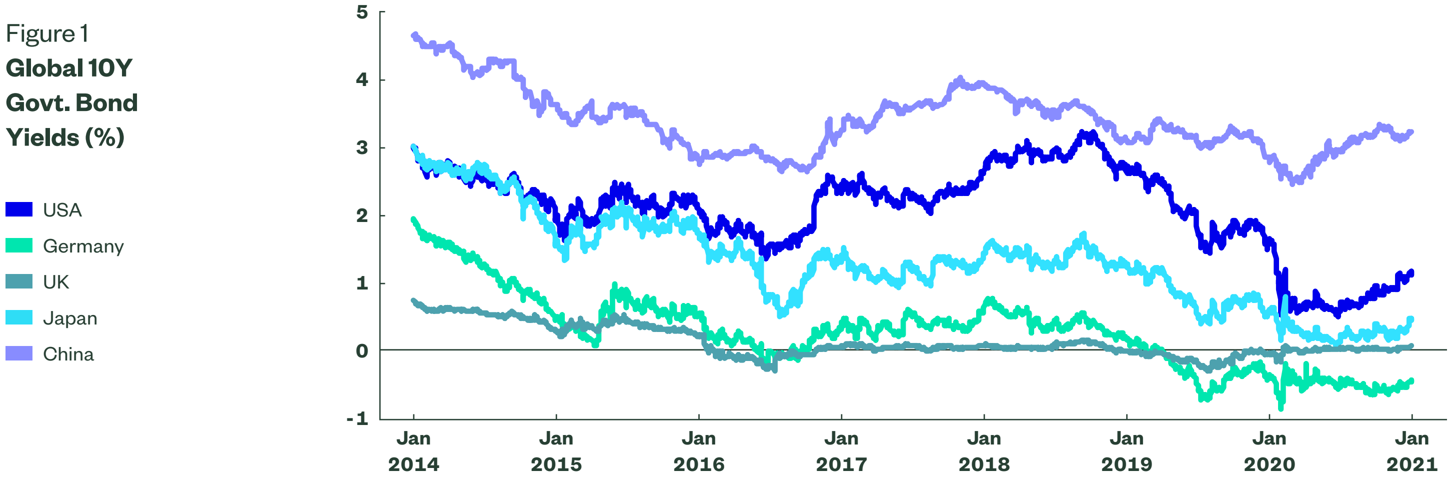
Developed Market Sovereign Bond yields are likely to remain rangebound around historic lows, for some time, due to Quantitative Easing (QE). The US Fed, for example, is likely to maintain its policy rate at (or near) zero for the foreseeable future as it seeks to achieve its desired outcomes of lower unemployment and higher inflation.

In this environment, investors will increasingly need to turn their attention away from government debt to fixed income offerings that provide more substantial yields.

What's Wrong with Developed Market Government Bonds? (Contd.)

The graph below makes clear why it might make sense to underweight these core "risk-free" Developed Market Government Bonds:

Figure 1
Global 10Y Govt. Bond Yields (%)



Source: State Street Global Advisors, Bloomberg Finance LP. Data as of February 2021.

Generic Bond Yields (%)	1Y	3Y	5Y	7Y	10Y	20Y	30Y
US Treasuries	0.06	0.18	0.46	0.82	1.17	1.78	1.97
UK Gilts	-0.06	0.01	0.08	0.24	0.48	1.01	1.07
JGB	-0.13	-0.13	-0.11	-0.06	0.05	0.44	0.65
Germany	-0.67	-0.74	-0.69	-0.63	-0.45	-0.21	0.01
Netherlands	-0.64	-0.71	-0.66	-0.58	-0.39	-0.09	0.07
France	-0.64	-0.68	-0.61	-0.48	-0.23	0.24	0.53
Italy	-0.44	-0.29	-0.03	0.18	0.53	1.14	1.44
Ireland	-0.61	-0.62	-0.53	-0.40	-0.14	0.10	0.46
China	2.60	2.50	2.73	2.46	2.43	–	–

Source: State Street Global Advisors, Bloomberg Finance LP. Data as of February 2021.

Just as we currently see challenging valuations in equities, the same applies to DM Government Bonds. We have negative real, if not nominal, yields pretty much across the board, as shown by the growing sea of red in the grid above.

This is also accompanied by higher risk (as yields fall, duration automatically rises for the same maturity bonds. Sovereigns have also been taking advantage of rock-bottom yields and flat curves to issue further and further out). In other words, DM Government Bonds are far from risk-free, and we think the risk they have is very poorly rewarded. They are — as much as some sectors of the equity market — priced to perfection, and there is similarly no cushion for any nasty surprise, however remote (for example a spike in supply, or even inflation).

So, investors need to think hard about where to get that additional yield.

So, Where to Go?

While we can't point to real value in the credit space either, what we can say for sure is that there is a lot of support for corporate bonds from central banks in the major markets, so we at least don't see much downside there.

We prefer Investment-Grade Corporate Credit, where the US Fed and European Central Bank (ECB) buying programs have been effective in compressing spreads.

Ongoing Support for Credit

In 2020, proactive central bank efforts, including QE and purchase programs aimed at supporting credit market liquidity, played a major role in stabilizing and improving the trajectory of fixed income markets. We believe that these activities will continue to be a substantial factor as we look forward to 2021.

Support for Corporates

And there's more good news: The Fed was able to get a lot of 'bang for the buck' by simply signalling its willingness to make purchases. Since the March 2020 announcement of the Fed's Primary and Secondary Market Corporate Credit Facility programs, spreads have tightened dramatically, despite the very small volume of actual Fed purchases. This support has worked more as a signal similar to Draghi's famous 'Whatever it takes', effectively backstopping the market and bringing down spreads without the need for huge capital outlay. With such big buyers waiting in the wings we are comfortable maintaining our credit overweight.

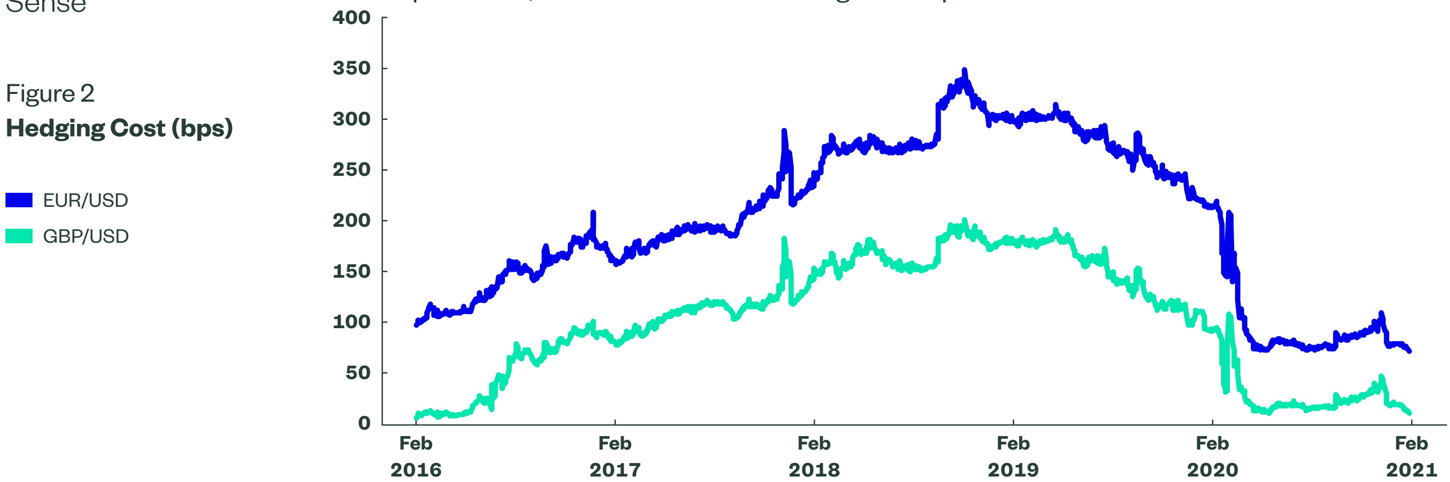
Similarly, the ECB launched its QE and started buying credit several years ago. Over that period, the ECB buying program has suppressed credit spreads in European markets. Investors know that.

The tidal wave of corporate issuance in 2020 has also served to strengthen balance sheets; this, combined with the likely support of the Fed in the event of an economic disruption translate to a favourable outlook for Investment-Grade Credit through 2021.

Investment Grade and High Yield Credit Make Sense

Both IG and HY credit are places to go for additional yield – credit is certainly well supported from a QE perspective – but we have a preference for IG, given that we're later in the cycle. With respect to HY, we're a little more cautious given the potential risk of default.

Figure 2
Hedging Cost (bps)



Source: State Street Global Advisors, Bloomberg Finance LP. Data as of February 2021.

When we look to credit, one favourable development for euro and sterling investors has been a drop in the hedging costs from USD back to euros/sterling, as the interest rate differential has collapsed, meaning that hedging dollar IG credit is attractive again for euro/sterling investors. There's a 75bps pickup in yield after hedging costs as can be seen in the chart, while preserving the benefit of lower volatility from hedged investments alongside the increased sectoral and regional diversification that international credit can offer.

Need More Income and Can Take More Risk?

So, hopefully we've convinced you to move out of DM Government Bonds, and into Investment-Grade Credit, global and hedged back to euros/sterling. But what if you need more income and can take more risk?

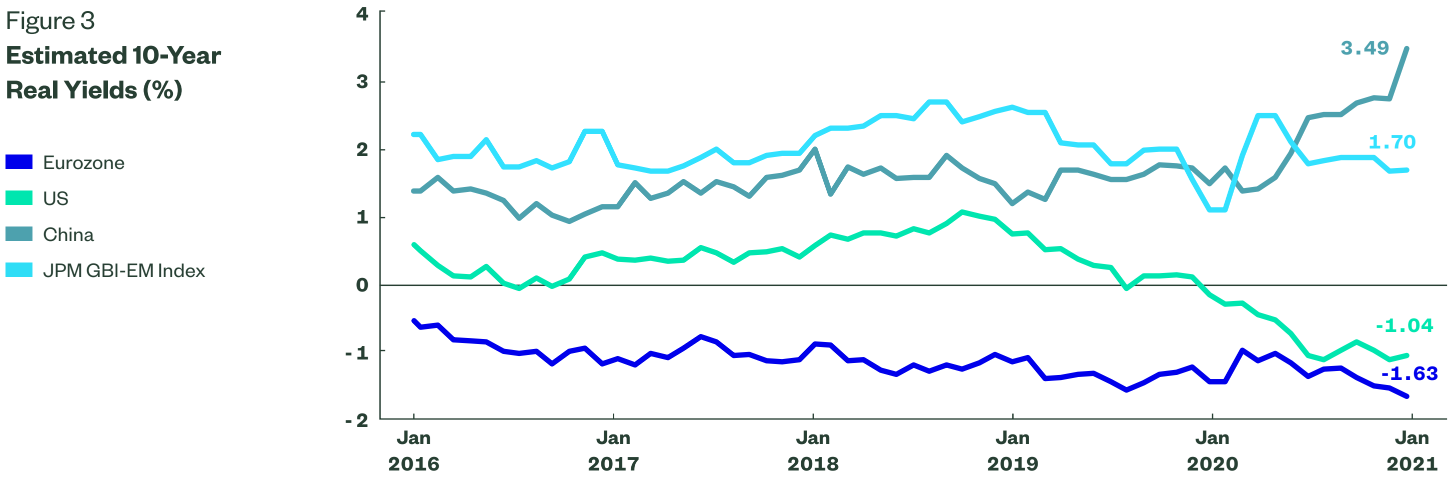
In that case, we think investors should pay attention to EMD. Within the EM complex, we think it makes sense to consider China.

In our 2021 Global Market Outlook we said that we think the US and China are two important economies that are going to shape 2021 from a GDP perspective. We also like China because of its relatively low correlation with other asset classes, both for bonds and equities. So, an exposure to China debt can offer fixed income investors a bit of diversification.

EM Local Currency Real Yields Offer Income

For clients who can move up in risk, we would point out that EM local-currency real yields remain attractive at current levels, and particularly when compared with US real yields, which from the beginning of the year have turned quite negative, as you can see in the graph below.

Figure 3
Estimated 10-Year Real Yields (%)



Source: State Street Global Advisors, Bloomberg Finance LP. Data as of January 2021.

We think a permanent medical solution to the pandemic crisis could see US real yields normalize and narrow the gap with emerging markets. This would lead to the relative outperformance of EM bonds with the potential for a further tailwind from currency.

EM Currencies Are Undervalued

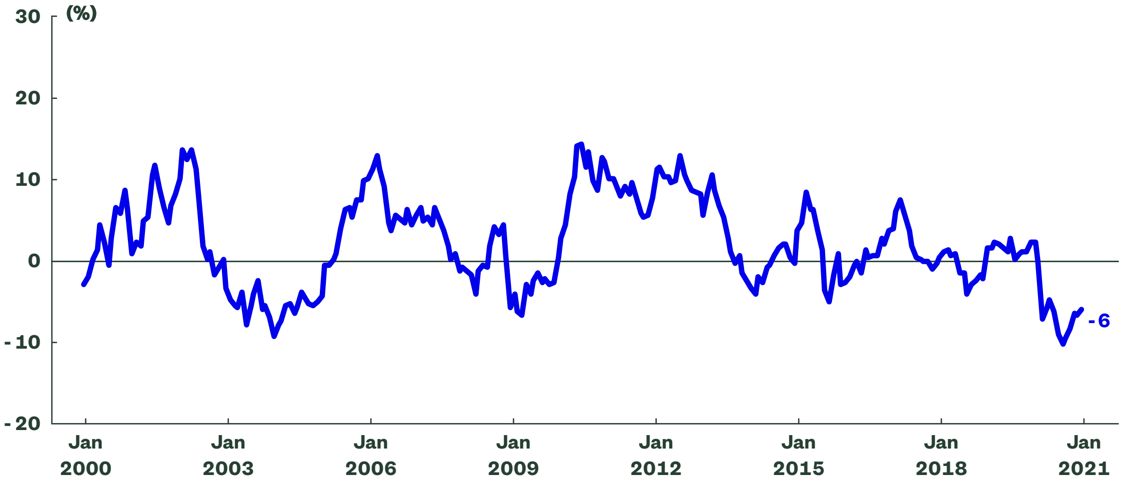
Another force that should influence your fixed income decision-making in 2021 is the secular bear market that we expect to take shape for the US dollar. Those expectations were reinforced by Biden, whose administration is likely to be both more friendly to global trade and more stable, reducing the risk of a downward-spiralling trade war.

These benefits for global trade will translate into a disadvantage for the dollar, although pandemic-related uncertainty and high levels of market stress have so far supported relatively high USD valuations. Those high valuations, paired with very low yields for the currency, are generating substantial pressure on USD to revert to fair value.

Currency is one of the main contributors of risk in local-currency bonds, and here we see that many EM currencies seem to be quite cheap. So, we think this is a good time for investors to be thinking about local-currency EMD and also at EM currencies as they consider their fixed income allocation.

This potential for a bear market in the US dollar, as well as the possibility that a return to risk would see EM currencies rally from their current steep undervaluation, together mean we think local-currency EM debt presents a particularly attractive opportunity: from an investor's perspective, EMD offers yield pickup.

Figure 4
EM FX Fair Value vs. EUR



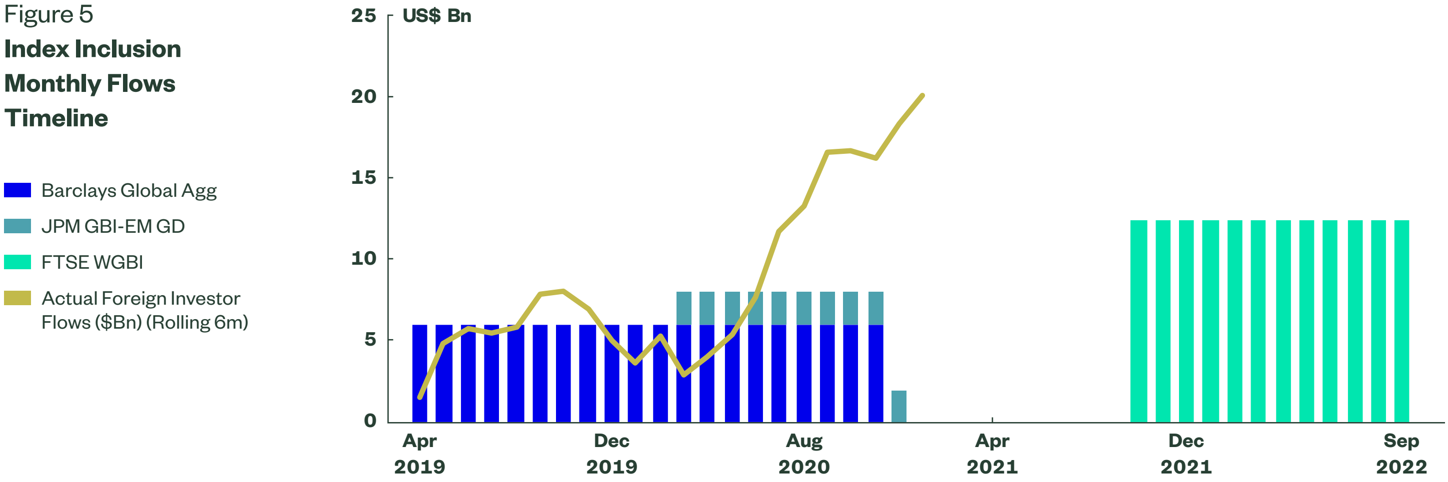
Source: State Street Global Advisors, Bloomberg Finance LP. Data as of January 2021.

China: Attractive Yield with Positive Technicals

China real yields remain attractive relative to other major developed markets. Inclusion in major indices translates to strong demand pull.

And within EM Debt we have seen increasing interest from clients for standalone Chinese bond allocations. Not only are the inflation-adjusted yields far more attractive than those in the US and eurozone, but there are structural reasons as well for their continued outperformance.

Figure 5
Index Inclusion Monthly Flows Timeline



Source: Barclays, Morgan Stanley for Actual Foreign Investor Flows. Data as February 2021.

The past two years have seen a general move toward greater internationalization of the renminbi. More capital controls are being removed, and generally we're seeing the entrance of Chinese bonds into various bond indexes. That trend is only likely to accelerate as time goes by.

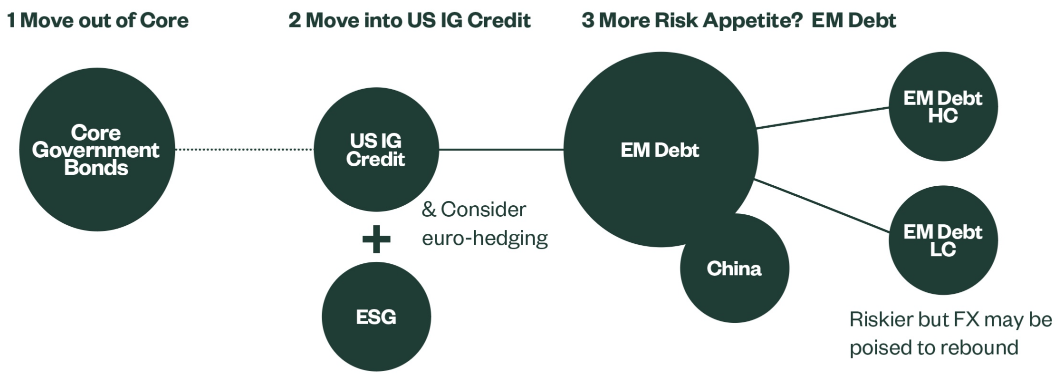
Investors' enthusiasm has also been bolstered by the resolute performance of China bonds through the crisis, where they showed enviable stability in price and liquidity, especially compared to their DM counterparts. China's bond market also exhibits relatively low correlation compared with other asset classes, with a risk profile that matches developed market bonds.

So Chinese fixed income assets may have much to offer investors over the next year, not just because of the potential for yield pickup, but also because we see room for appreciation.

The 2021 Game Plan

Clients need to move out of core Government bonds. US IG Credit is a good place to start, with hedging back to euros now looking attractive.

For those who can move further up in risk, EM Debt has a number of things going for it from a weaker dollar to a return to risk and structural flows. And Local Currency, we believe has the added catalyst of FX poised to rebound. Within EM, Chinese bonds are increasingly presenting characteristics — such as low correlation and attractive real yields — that many investors will find persuasive.



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- Invent the future

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