

2021 Core Markets Fixed Income Outlook: The curve, COVID -19 and Kamala

January 2021

By Steven Williams, Head Portfolio Manager, Core Markets

As European Commission President Ursula von der Leyen announced the free trade agreement with the UK and the EU, she quoted T.S. Eliot: "What we call the beginning is often the end. And to make an end is to make a beginning. The end is where we start from." Well, with the end of 2020 we certainly have a new year to look forward to, but it feels we are more like in the middle of this unsettled time than at an end. With viral cases rising and the Democrats now expected to take the US Senate (at the time of writing), the landscape has changed from only a month ago when we faced a no-deal Brexit, a Republican Senate and more virus rhetoric. With new mutant, more virulent strains of the virus, we have gone from bad to worse. The help from a vaccine is on the way, but full vaccination still remains far off on the horizon. Perhaps a quick vaccination lesson from the Israelis could speed things along? USD 4.5 trillion of total fiscal and monetary stimulus between Europe and the US is primed and ready to be implemented over the immediate term and we suspect there will be more to come as the most optimistic scenarios for the pace of vaccinations falter. It took nearly 30 years to eradicate polio in the US; we certainly think the eradication of COVID-19 will be faster, but current mid-summer herd immunity projections seem optimistic.

For rates, 2021 will be all about the curve, COVID-19 and Kamala. With the Democrats now likely to take control of the Senate, we expect a bit more of a reflation trade in the first half of the year with additional stimulus, a 15-dollar-an-hour minimum wage and support for states. While the immediate concerns over Democratic leadership are those of a radical progressive agenda, the reality is that Joe Biden will likely govern with a bipartisan approach given an already fragmented Democratic party and lack of a dominant majority. We recall when Donald Trump was elected, the market was sure of the reflation trade as well. Nevertheless, we ended up with historically low interest rates. We think once the reality of low growth for longer sets in, the "Bond Vigilantes" will be forced back by the "Justice League of Central Banks" faced with taming a steepening yield curve constraining the recovery.

Inflation will certainly be an issue, and we expect some wild numbers from headline inflation as base effects will come into play versus the spring 2020 figures (e.g. how do you calculate growth off of a negative oil price?). Inflation, though, will be just an illusion as it will face the new regime of innovation, competition, debt, deficits and now zombie companies. The record amount of US Treasury cash, USD 1.56 trillion, stands at odds with money market demand for US Treasury bills and we doubt the Federal Reserve (Fed) would want the market to dictate terms on short-term interest rates. US municipals will benefit from the push for added stimulus with likely larger grant packages coming for state and local credits and a more than likely resurgence of a Build America Bond-style program. With nearly everything looking expensive in credit, taxable municipal bonds remain a solid value standout.

We expect to see a summer lull in the virus as we observed last year, but as with the 1918 influenza pandemic, we cannot discount the impact of a potential third wave going into the 2021 autumn period, especially for emerging economies. Growth will remain suppressed throughout the year, and stimulus will remain high. We expect the USD decline to continue, but only to a point. To think the rest of the developed market economies will stand idly by and allow for the relative debasement of the USD would seem foolhardy, though quite difficult to know if there will eventually be a breaking point. Commodity currencies will continue to benefit on the road to recovery with the Australian, New Zealand and Canadian dollars and Norwegian krone benefitting from the resurgence in commodity prices, especially in a weak USD environment.

Since Trump took office in 2016, he has lost the presidency, the House and now likely the Senate. We think it is possible that the Democrats take a more pragmatic approach to the main issue at hand, the pandemic, and focus on stimulus for now. While Biden ran on taxes, the election was so close that we question the incentive to taunt the elephant given the risk of a Senate flip in 2022. As such, we are not entirely convinced of a Biden tax raise just yet. In the second half of the year the discussion of the Fed chair will become centre stage. We would make the same argument for choosing the Fed chair: why risk 2022? We think the ongoing stimulus will continue to exacerbate the wealth gap, especially increasing the number of easy-to-vilify centibillionaires, thereby leaving the Fed ripe for politicisation. Our main concern is the idea of recession insurance bonds, which are basically “helicopter money” for main street. Though enacting this would require the Democrats a solid majority, which they don’t have.

For Europe, with USD 1.5 trillion of QE to be deployed over the course of 2021, we expect the convergence trade to continue with Italian sovereign spreads to be the main beneficiary. We expect Italian spreads to grind towards Spain over the course of 2021, as the search for yield and central bank protective put will keep volatility low and the incentive for the carry trade high. For the broader EU, we think Sweden and Denmark remain attractive alternatives given their high-quality ratings and still-high spread relative to Germany, as capital will continue to reallocate to higher yielding alternatives without sacrificing quality.

Historically, we know all pandemics end, but some linger on as chronic endemic issues. Looking back to the 1918 influenza pandemic, we know third waves and even fourth waves are possible, especially when considering the logistical challenges of rolling out a vaccine globally. However, as tough as they are, pandemics are no match for central banks. While historical recessions always incorporated a prolonged shift in asset prices, the new normal seems to have solved the asset price side of the equation, just not the general income side of it. It’s become a clichéd term, but we remain cautiously optimistic for 2021. At least we can look forward to not discussing Brexit.

Important information: This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute personal investment advice or a personal recommendation and it does not consider in any way the objectives, financial situation or needs of any recipients. All recipients are recommended to consult with their independent tax, financial and legal advisers prior to any investment.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this document will not affect Nikko AM’s investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual securities, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom and rest of Europe: This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (the FCA) (FRN 122084). This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the FCA in the United Kingdom, and is directed at professional clients as defined in the FCA Handbook of Rules and Guidance.

United States: This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information to institutional investors as defined in the Securities and Futures Act (Chapter 289), and intermediaries only. Nikko Asset Management Asia Limited (Co. Reg. No. 198202562H) is regulated by the Monetary Authority of Singapore.

Hong Kong: This document is for information to professional investors as defined in the Securities and Futures Ordinance, and intermediaries only. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: This document is issued in Australia by Nikko AM Limited (ABN 99 003 376 252, AFSL 237563). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

New Zealand: This document is issued in New Zealand by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Holdings group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

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

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

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

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

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

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