# GLOBAL RATES OUTLOOK

By Simon Ballard

More than just global markets, the globe itself was preoccupied and dominated by one event during the course of 2020: Covid-19. Furthermore, the evolution of the pandemic, as vaccines are distributed, will likely be the key macro driver of investor sentiment, and by extension, the direction of global interest rates over the course of 2021.

The unprecedented crisis faced by the world's economy during 2020 saw a similarly unprecedented policy response from central banks and governments around the world. Interest rates were slashed drastically amid systemic monetary easing, while the fiscal sluice gates were opened to their maximum. But after the sharp contraction in global growth in 2020 (-4.4% according to the IMF, as of December) and optimism regarding a return to positive economic growth in 2021, the important question for the year ahead will likely be: to what extent might these historically low levels of interest rates and extreme fiscal stimulus measures create a fertile base for a return to pre-pandemic growth rates?

Interest rates and government bond yields were already low before the effects of the pandemic took hold, after which they were then reduced to the bone. While the nadir of the current global economic cycle probably occurred in Q220, marking the low point for global rates sentiment, the policy rates of developed country central banks are likely to remain accommodative and with a consistent easing bias throughout 2021. Any normalisation of rates back towards pre-Covid levels will probably only begin to transpire beyond 2022.

This said, a modest bear-steepening trend could continue to characterise yield curves this year, as long-term rates sell off in response to Covid-19 vaccine optimism and a subsequent improving macroeconomic horizon begins to come into view. But this steepening bias will probably be dampened by a generally modest global inflation outlook and dovish central bank bias for the foreseeable future. Should the bear-steepening trend gather uncomfortable momentum and thereby threaten economic recovery prospects, central banks are expected to respond swiftly with new quantitative easing (asset purchase) measures, given the limits of the monetary policy ammunition at their disposal.

The government and central bank response to the painful effects of economic lockdowns and social distancing last year were unprecedented. Interest rates were slashed dramatically, and fiscal stimulus measures were implemented to the extent that sovereign balance sheets ballooned exponentially. Moreover, with Covid-19 still some way off being fully-contained, this monetary and fiscal dynamic does not look likely to change in the near-term.

The Pfizer/BioNTech vaccine and others are now being rolled out globally. Couple this with zero-bound short rates and extensive fiscal accommodation, as well as a consequently more buoyant macro outlook for this year and 2022 should continue to feed a renewed bear-steepening bias in yield curves going forward.

While the global economy was firmly entrenched in recession during most of 2020 (with the paradoxical exception of China, that will be the only major economy to have registered full year positive GDP in 2020), 2021 will probably be marked by a recovery to modestly positive growth, which should be followed by a modest sell-off in long tenor rates.

Also, as a result of the stimulus measures implemented in the US over the past ten months, there is now an eye-watering amount of Treasury issuance on the near-term calendar. Together with hopefully improving fundamentals, this will only add further momentum to the yield curve steepening trend.

#### The negative interest rate polemic

The debate over possible negative rates in the US and the UK has attracted more followers in recent months, and will likely continue to do so through much of 2021. In aggregate though, there may be limited benefits from such a move, particularly given the lack of positive evidence from the Eurozone's project in that respect with its -0.5% deposit rate.

Money market rates can trade below 0% while policy rates are at, or flirting with, the zero per cent bound. But, for the Federal Reserve or Bank of England to make negative rates work in terms of making cash penal enough to spark a meaningful rotation into higher risk, higher-yielding assets, that would probably require rates to be slashed to -2% or -3%. Replicating the ECB's token -0.5% would likely have little impact.

## US rates

Fed chair Powell and the rest of the Federal Open Market Committee have made it quite clear in recent months that US policy rates will remain 'low for longer', with the Fed funds target rate anchored around zero. Moreover, given the Fed's new average inflation targeting strategy, any shift by the central bank towards a tighter monetary bias appears unlikely before 2023. This should remain the case even if the Biden administration's fiscal stimulus turns out to be much larger than currently expected.

Meanwhile, although longer-term interest rates and yields will edge higher with improving macroeconomic expectations, the persistent need for structural quantitative easing support, coupled with muted inflation, should help to keep the steepening bias moderate, as mentioned above. Such a dynamic is what the global economy needs in 2021 in order to claw its way back to recovery from the damage of 2020's lockdown recessionary pressures.

With the US Fed funds rate pinned around 0% in Q4 2020, and the yield on ten-year US Treasuries having risen sharply toward 0.90% in December 2020 on the back of coronavirus vaccine optimism, the premium of ten-year yields over two-year US Treasuries has risen steadily through 2020, from a low of 12 basis points, to around 80 basis points in December.

Yield curves could steepen further, and the premium between two-year and 10-year bonds could reach as high as 125 basis points in the first quarter, as longer-term yields drift higher on the coat-tails of Covid-19 vaccine optimism.

## European rates

European policy rates should maintain a more dovish bias during 2021, compared to those in the US. Eurozone GDP is not forecast to return to pre-pandemic levels until the end of 2022 (versus the anticipated recovery in US GDP to pre-Covid levels by end-2021), which will require the ECB and national governments to keep their feet even more firmly on the policy accommodation and stimulus pedals during 2021. The ECB, with its already negative deposit rate, has very few 'new' policy tools in its arsenal.

Such a scenario offers little encouragement for investment, which in itself will dampen economic recovery hopes.

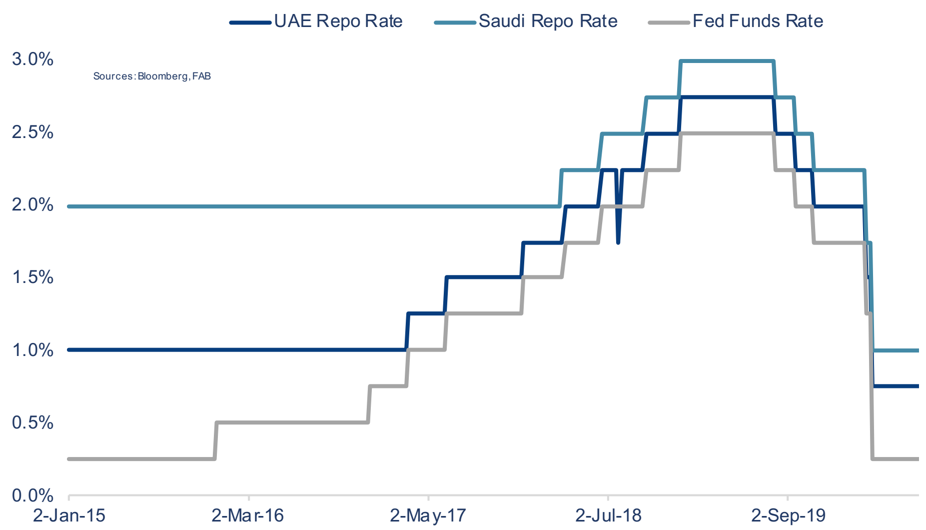
However, while many European countries' debt-to-GDP levels have expanded exponentially in recent months, as governments have injected fiscal measures in an effort to cauterize the economic downturn, the fact that the ECB remains the marginal buyer of associated debt means the upside pressure on longer-term European rates should remain modest.

Indeed, with global rates at the zero bound, central banks in general now have limited ammunition to deal with any second or third wave of the pandemic.

## GCC Rates Outlook

We anticipate a recovery in GCC regional economic growth in 2021, recovering from the expected 4% or so contraction in 2020, to positive expansion of around 2.4%-2.5% of GDP in 2021. This should support a pattern of bear-steepening yield curves across the region, similar to that anticipated in the US market.

Nonetheless, with the near-term global macro-outlook remaining fragile for some time, as the Covid-19 pandemic leaves a costly structural legacy around the globe, the front end of the yield curve across GCC geographies will



probably remain reasonably well anchored. There will be no sharp sell-off in rates in 2021, in our view.

This said, improving economic prospects in the UAE during 2021 should give some modest upside momentum to the entire yield curve next year. As such, we anticipate the three-month Emirates Interbank Offer Rate (EIBOR), which has traded sub-0.50% for much of the final quarter of 2020, could drift modestly higher during 1H21. The rate could touch 0.75% by Q221, from levels of around 0.46% in mid-December 2020, albeit still dramatically lower than the 2.23% level at which it traded in December 2019.

At the same time, increasing optimism around vaccine rollouts, and a recovering macroeconomic landscape should be a fillip for risk appetite, and fuel a softer bias for long-end rates. Again, we expect bear-steeping to be the overarching theme for the GCC rates market in 2021, albeit not linear, and likely interspersed with bouts of volatility and periodic risk aversion and haven trades.

## UK Rates

The UK economy sank sharply in Q2 2020 as a result of the coronavirus lockdowns, with the UK manufacturing PMI index plunging to a record low of 32.6 in April. While activity has recovered – the manufacturing PMI was up at 57.3 in December – the spectre of further lockdown restrictions in the early months of 2021 makes for a fragile and opaque outlook at best.

Therefore, the dominant bias in UK rates and monetary policy should remain dovish over the coming year, with the Bank of England's asset purchase programme being the marginal tool of any near-term additional policy accommodation, should it be required. More importantly perhaps, in line with that of the Federal Reserve's FOMC, there is very little possibility of any monetary tightening by the BoE MPC until 2023 at the earliest.

The BoE announced a larger-than-expected increase to its quantitative easing programme in November 2020 – ramping up its asset purchases by an additional 150 billion pounds, to take the overall size of the programme to 895 billion pounds. The move was a clear reflection of the Bank's fears with regard to the likely economic costs of the round of economic and social distancing restrictions imposed across much of the UK in late 2020.

The BoE will now carry a much more dovish rates tone into 2021, fuelled by reduced fiscal support and growing trade uncertainty due to Brexit. This said, the Bank will surely be hoping to avoid any need to dive into negative rate territory in 2021, while also hoping – perhaps in vain – to be able to scale back its dovish rhetoric during the course of the coming year.