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Simon Ballard
Chief Economist

FAB House View: Global Rates (2020/2021 Outlook)

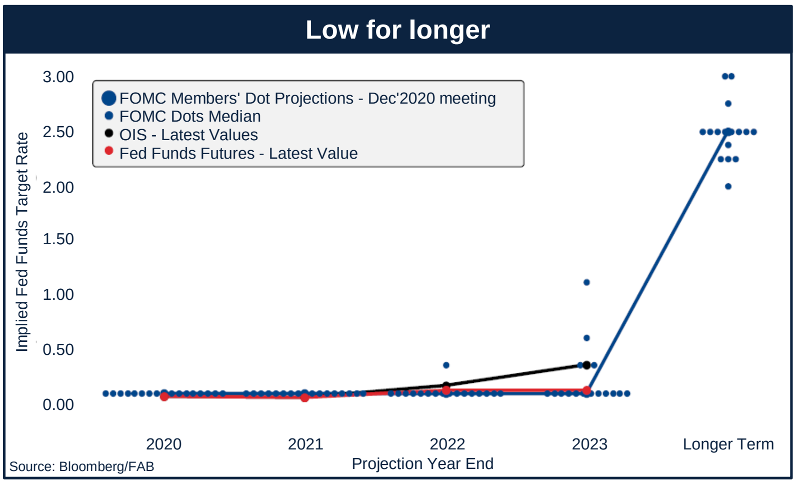
The Bear Necessities

- Bond yields and interest rates staying low, but generally positive, in 2021
- But global optimism with regard to a coronavirus vaccine will be a key tailwind for global rates market sentiment over the coming quarters
- Improving global macro assumptions will fuel a non-linear, softer bias in long end rates, albeit interspersed with bouts of volatility and periodic risk aversion
- With the front end of the yield curve well anchored; bear steepening should be the theme for year ahead
- Brexit could be the final straw to trigger negative rates in the UK

More than just global markets, the globe itself was pre-occupied and dominated by one event during the course of 2020; Covid-19, coronavirus. Furthermore, the evolution of the pandemic, as medical experts continue their scramble to find, prove and distribute a vaccine for the pathogen, will likely be the key macro driver of investor sentiment and by extension the direction of global interest rates over the course of 2021.

Low rates here for the foreseeable future

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.



Source: Bloomberg/FAB

But after the sharp contraction in global growth in 2020 (-4.4% according to the IMF) and optimism toward a return to positive economic growth rates in 2021, the question for the year ahead will be to what extent might these historically low levels of interest rates and extreme fiscal stimulus measures now create a fertile base for a return to re-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 stripped to the bone. Whilst we are optimistic that the nadir of the current global economic cycle occurred in Q2 2020 and that this also marked the low point for global rates sentiment, we are under no illusion that global policy rates (U.S. Federal Reserve, the European Central Bank along with other developed market central banks) will remain anything but accommodative, with a consistent easing bias, throughout 2021. Normalization of rates back toward pre-Covid levels will likely only begin to transpire beyond 2022.

This said, we continue to expect a modest bear steepening trend to characterize 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 we are also cognizant that this steepening bias will 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, we would expect central banks to respond swiftly with new quantitative easing (asset purchase) measures. We will argue that they currently only have limited monetary policy ammunition at their disposal.

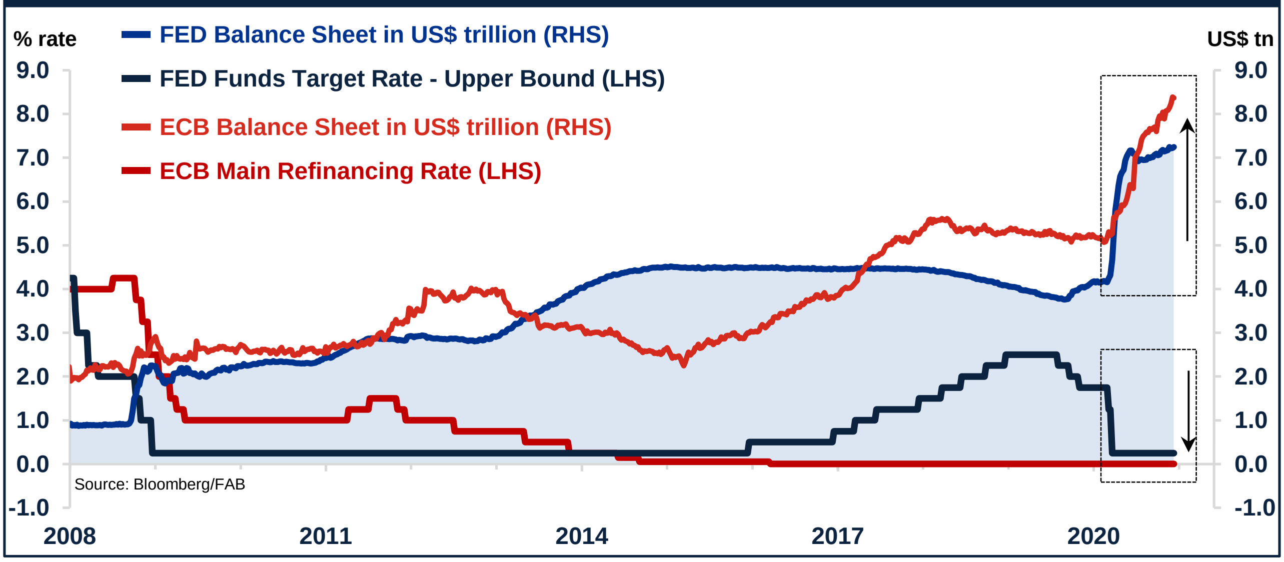
There were of course several drivers of volatility and investor uncertainty during 2020, all concurrent with the spiralling and spreading coronavirus infection that has effectively cratered the macro economic landscape. And as infection numbers continued to rise towards the end of last year and into 2021 – especially in the US and across parts of Europe – we would conjecture that the authorities really do need to keep working on containing the virus until a proven vaccine is has been rolled out and a sizeable portion of each country's respective population has been inoculated.

We have felt the painful effects of economic lockdowns and social distancing this past year, the government and central bank response to which was 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 formally contained (global cases had topped 63 million as of early December 2020 resulting in almost 1.5 million coronavirus-associated deaths), this monetary /fiscal dynamic doesn't look likely to change in the near-term.

The price of recovery

As such, the outlook for global rates will hang essentially on the prospects for a Covid-19 vaccine. Market sentiment has been – and will continue to be – buoyed and buffeted by the euphoria and optimism over the latest Covid vaccine trials. Similarly, any disappointments and setbacks in the search for a coronavirus panacea will surely be punished by global rates and risk asset pricing.

Keeping the policy sluice gates open



The assumption is though that the globe is on the cusp of finding successful vaccines, with Pfizer/BioNTech vaccine now already being administered in the UK. Couple this with zero bound interest rates and extensive fiscal accommodation and a consequently more buoyant macro outlook for this year (2021) and 2022 should continue to feed a renewed bear steepening bias in yield curves going forward.

So, while the global economy was firmly entrenched in recession during 2020 – with the paradoxical exception of China that will be the only major economy to have registered full year positive GDP in 2020 – we are anticipating a recovery to modest positive growth and modest selloff in long tenor rates in 2021.

It's important to note also that as a result of the stimulus measures implemented in the US over the past 10 months that 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 picked up more followers in recent months and will likely continue to do so through much of 2021. In aggregate though, we would argue that there would be limited benefits from such a seismic move of taking generic interest rates into negative yield territory, particularly given the lack of positive evidence from the Eurozone's project in that respect with its -0.5% deposit rate.

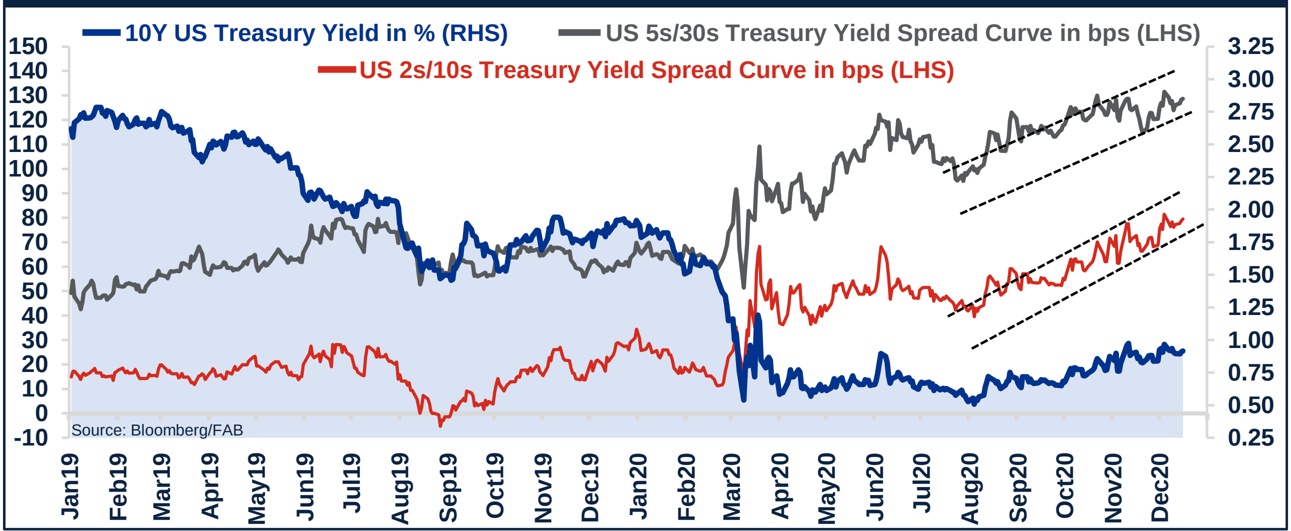
Money market rates can trade sub-0% while base rates are at or flirting with the zero percent bound. But, for the Federal Reserve or the Bank of England to make negative rates work in terms of making cash penal enough to spark a meaningful rotation into higher risk, i.e. higher yielding assets, we would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

U.S. rates

Fed chair Powell and the rest of the FOMC have made it quite clear in recent months that U.S. policy rates will remain 'low for longer', with the Fed funds target rate anchored around the zero percent bound. Moreover, given the Fed's new average inflation targeting strategy, we do not currently anticipate any shift by the central bank toward a tighter monetary bias before 2023. The latter should remain the case even if the Biden administration's fiscal stimulus turns out to be much larger than currently expected, given the divided nature of Congress.

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 in check. 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.

Bear steepening optimism



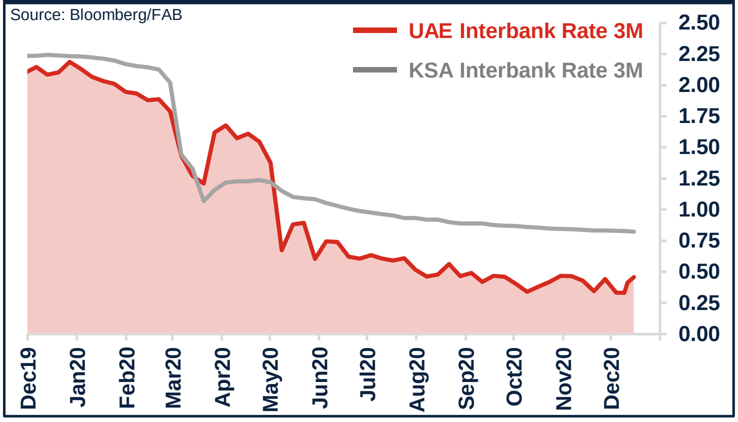
With the U.S. Fed funds rate pinned around 0% in Q4 2020 and the U.S. 10y yield having risen sharply toward 1% in December 2020 on the back of coronavirus vaccine optimism, the headline 2s/10s yield curve spread rose steady through 2020 from a low of 12bps to around 80bps in December. As longer-term yields drift higher in early 2021 on the coattails of Covid-19 vaccine optimism, we would expect to see yield curves steepen further, with the aforementioned 2s/10s expected to rise to around 125bps during Q1 2021.

GCC rates

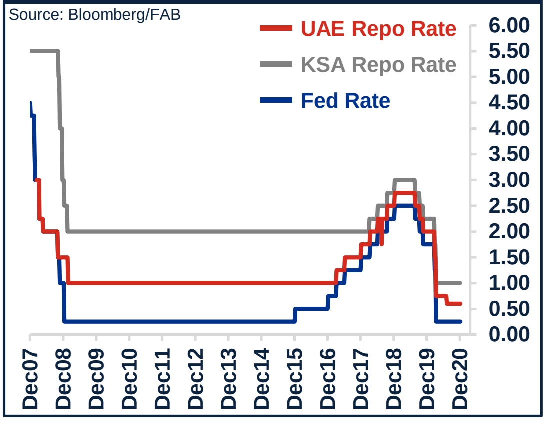
As discussed previously, we anticipate a recovery in GCC regional economic growth in 2021, recovering from the (expected) 4%-or-so recessionary conditions in 2020 to positive expansion of around 2.4%/2.5% GDP growth in FY2021. This should support a pattern of bear steepening yield curves across the region, similar to that anticipated in the U.S. 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, we expect the front end of the yield curve across GCC geographies will remain reasonably well anchored. There will be no sharp selloff in rates in 2021, in our view.

Plotting the road to the recovery



UAE, KSA Repo Rate vs Fed Rate



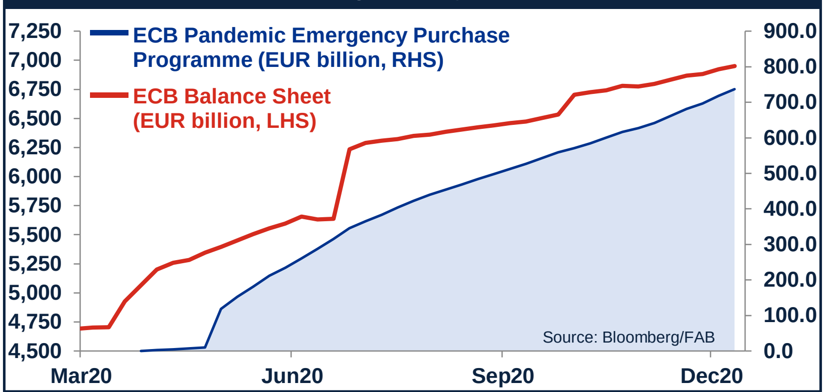
This said, improving economic prospects in the UAE during 2021 should give some modest upside momentum to the entire yield curve next year. As such we anticipate that the 3-month Emirates Interbank Offer Rate (EIBOR), which has traded sub-0.50% for much of the final quarter of 2020, will see a modest drift higher during 1H21. From current levels of around 0.46%, the rate could touch 0.75% by Q2 2021, albeit still dramatically lower than the 2.23% level that it traded at in December 2019.

At the same time, increasing optimism toward vaccine rollouts and a recovering macroeconomic landscape should be a fillip for risk appetite and fuel a softer bias to 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.

European rates

European policy rates will maintain a more dovish bias during 2021, compared to those in the U.S. Eurozone GDP is not forecast to return to pre-pandemic levels until end 2022 (versus the anticipated recovery in U.S. 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. We are also cognizant that the ECB – with an already negative deposit rate – has very few 'new' policy tools in its arsenal.

ECB remains the marginal buyer of Eurozone bonds



Such a scenario offers little encouragement for capex, which in itself will dampen economic recovery hopes. Moreover, recovery toward trend-rates of growth will only be a bi-product of a proven and widely distributed Covid-19 vaccine, which will permit governments to lift economic restrictions.

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 that the upside pressure on longer-term European rates should remain modest.

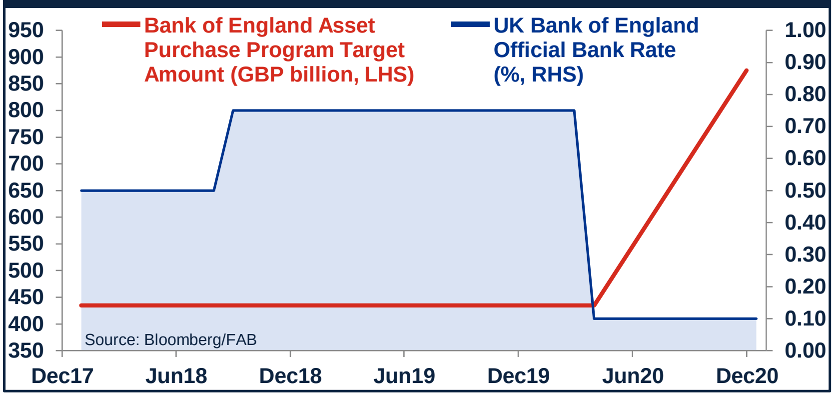
Indeed, with global rates at the zero bound, central banks in general now have limited ammunition to deal with any second or third wave of the pandemic over the coming months.

U.K. Rates

There is only one direction that interest rates may trend in the UK during 2021; lower. While we do not anticipate any move in Bank Rate from the Bank of England during 2021, the possible pressures from Brexit may yet force the Bank of England into an emergency interest rate reduction. Moreover, the BoE will be cognisant of global macro weakness, meaning that the MPC will need to fine-tune monetary policy to support activity, keep inflation close to target and hedge for potential (external) shocks. The Bank Rate is already at an historic low of 0.1000%, so it would perhaps not take much to shift the BoE's thinking into the uncharted waters of negative interest rate territory.

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 over the coming months makes for a fragile and opaque outlook at best.

Overarching bias to UK moneratry policy remains dovish



If anything, therefore, the overarching bias to UK rates and monetary policy will remain dovish over the coming year with the BoE's asset purchase program 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 FOMC we certainly do not see any possibility for monetary tightening by the BoE MPC until 2023 at the earliest.

The BoE announced a larger-than-expected increase to its quantitative easing program in November 2020 – ramping up its asset purchases by an additional GBP150 billion, to take the overall size of the program to GBP 895 billion. The move was a clear reflection of the Bank's fears with regard to the likely economic costs of the latest round of economic and social distancing restrictions imposed across much of the U.K.

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.

Simon Ballard
Chief Economist
Market Insight & Strategy
FAB Global Markets
Tel: +971-2-6110012
Mobile: +971-50-933-2806
Email: Simon.Ballard@bankfab.com

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