As we move into the second half of the year, and as the global pandemic appears to be petering out, we believe there are three key themes that will likely influence markets in the months ahead: post-pandemic inflation risk, the future impact of current fiscal and monetary responses and a new set of green targets.

Post-pandemic Inflation Risk
The pandemic has created huge disruptions globally, and as a result we are now seeing higher inflation on the back of an unprecedented economic recovery in countries such as the US. But is this transitory or permanent?

We believe the surge in inflation is due to multiple factors. Pent-up demand after a lack of spending for the last 15 or so months. Supply chain disruptions where we are seeing shortages of everything from computer chips to building materials.

Supply/demand labour market inefficiencies where labour shortages could be due to a variety of factors such as a higher savings rate or that economies are transitioning to a lower-carbon model. Meanwhile, within the commodities space, the world is beginning to transition away from fossil fuels; we believe this is driving demand for other mineral as well as a likelihood of a reduction in supply, which could drive-up prices.

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Since the April-May high inflation print, the debate at the Federal Reserve (Fed) seems to have shifted, and they are now debating how transitory they think these higher inflation rates are likely to be.

In turn this has moved some voting Fed members to consider increasing the short-term federal fund rate in 2023, or possibly sooner. We expect the debate around tapering, interest rates, inflation and overall economic growth to continue and cause periodic volatility in rates and potentially risky assets.

The Forward-Looking Impact of Fiscal & Monetary Responses

Fiscal and monetary responses are aimed at increasing potential output and transitioning to a lower carbon economy. How will this affect long-term financial market stability?

We do not expect a sudden return to austerity and a reduction in stimulus as we saw a decade ago. Instead, we believe stimulus is likely to remain elevated, in part due to increasing commitments to tackle climate change. Central banks are the primary purchasers of the extra debt being issued. As Fig. 1 highlights, COVID-19 triggered a record fiscal deficit since March 2020, while the Federal Reserve’s balance sheet has doubled in size.

We also question how much central banks can step back if governments continue to have large funding needs. We believe we are entering a new era which could lead to a potential increase in volatility.

A New Set of Green Targets

Meanwhile, we are also seeing changes due to the climate transition challenge to net zero. Despite the disruptions of the pandemic and lockdown measures, we only saw an 5.8% reduction in carbon emissions by the energy sector in 2020¹, which falls short of the 7% annual reduction in line with the Paris Agreement.

This is an indication of the level of the challenges we are facing if we want to adhere to net zero by 2050. We are already seeing increasing actions from governments, asset managers, corporates and society as a whole and we expect this transition is likely to move to the heart of fiscal stimulus, economic transformation and job creation going forward.

A Different Correlation Regime

How will these transitions impact credit markets? Last year central banks provided liquidity and confidence in a period of crisis, which led to a fall in interest rates and global total returns driven primarily by rates.


The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy. Source: ICE Bank of America Merrill Lynch Indices as of December 31st, 2020. Returns are in USD. COAO - ICE BoFA ML US Corporate Index. JOAO - ICE BoFA ML US Cash Pay High Yield Index. ER00 - ICE BoFA ML Euro Corporate Index. HE00 - ICE BoFA ML Euro High Yield Constrained Index. EMIB - ICE BoFA ML High Grade Emerging Markets Corporate Plus Index. EMHB - ICE BoFA ML High Yield Emerging Markets Corporate Plus Index. Index performance is for illustrative purposes only. You cannot invest directly in the index. Reference to $ is USD. Index performance is for illustrative purposes only. You cannot invest directly in the index.

Fig. 2 – Total Returns Structure in 2020

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This year, as we see the global economic recovery gain momentum and we move from a period of deep recession to high growth, return drivers have changed. This is good for credit but not for rates.

We are now in an environment of rising interest rates, influenced by central bank policy, and rising inflation expectations. In this environment we are therefore focusing on credit markets with more spread and shorter duration (i.e., rates) exposure, such as US and emerging market high yield.

In addition, in terms of asset class exposure in our multi-asset credit portfolios, we believe emerging market corporate credit appears attractive. While the emerging market economies are slightly behind the global economic recovery, we are seeing them return to growth and repair themselves post pandemic.

Tight Valuations Come with Low Dispersion

Valuations are tight however as the global economic recovery has long been anticipated and priced into credit. We therefore see very little dispersion in asset classes such as US and European high yield, as well as on a sector basis. Everything is compressed by quality and duration. Nevertheless, we believe this environment appears favourable for active management. We need to pay attention to fundamental credit analysis and ensure we move out of sectors and issues we believe are overvalued.

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These will take some time to play out however, and we are still in the very early stages. But this is where active management can apply to ensure investors are positioned appropriately to weather these changes.

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