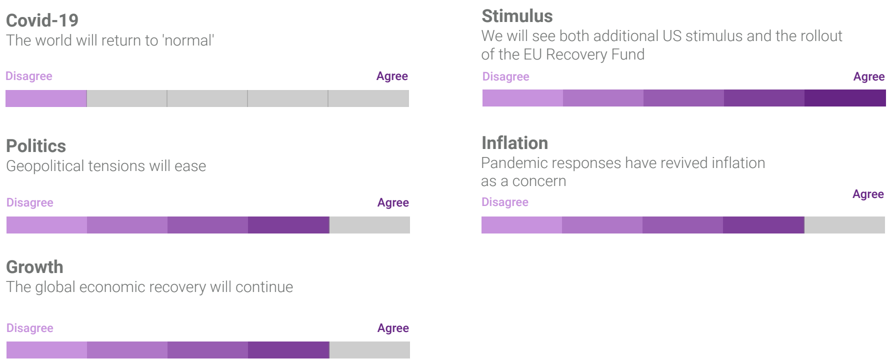
Quest for yield continues amid mammoth QE

2021: Outlook in a nutshell



Risk-on / risk-off

The result of the US election and the development of various vaccines have considerably decreased the uncertainty around the forthcoming cycle. Volatility indices have plunged and the market has resolutely embarked on a risk-on path.

Our central case scenario, a gradual economic recovery, is consistent with uncertainty remaining at a decently low level. A large part of the recent market performance can be attributed to a catch-up phase. Hence, in this scenario, the market should remain well oriented throughout 2021, even if the recent positive news is already to a large extent included in prices.

A risk-off period is plausible as a result of a market over-adjustment, or an external shock such as a new pandemic, a jump in inflation, or a premature fiscal tightening.

The search for yield

This is definitely the most worrying question for most investors, with global negative-yielding debt nearing $18 trillion in mid-December 2020. Meanwhile, more than 70% of global fixed income assets are delivering less than 1% yield.

Market practitioners are nevertheless hungry for yield and are scratching their heads to find ad-hoc solutions.

These have included going longer on the curve to pick fewer bp, looking lower in the capital structure (subordinated or hybrid against senior debt) in IG credit, increasing HY allocation, allocating to emerging market debt, seeking mezzanine tranches of ABS (including CLOs), or even allocating to peripherals to get a decent pick-up versus Bunds.

No matter what, central banks will continue to be ultra-active with mammoth QE programmes in 2021 that will support risk assets. Despite forecasts of slightly higher yields for the 10-year Bund (-0.30%) and 10-year Treasury (1.30%), we expect the present low-yield environment to persist into 2021.

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2021's top risks ranked

1. Rising inflation
2. Lack of fiscal stimulus
3. Rising default rates
4. US-China geopolitical tensions
5. Mass unemployment