

2021 THE YEAR OF NORMALISATION

Fixed Income Committee - 2021 Outlook

Normalisation: is defined as the process of bringing or returning something to a normal condition or state. After almost one year since the explosion of this unprecedented crisis, normalisation from a "social" point of view is really the wish that we all make for the New Year, i.e. going back to a "normal" life. This will also be true for the macroeconomic picture, after years of tensions, fears, geopolitical turmoil, the Global trade war and finally, the major sanitary crisis in history. **[Nicolò Bocchin (Luxembourg)]:** "In 2021, with the vaccines, the departure of Trump which has been the major source of global disputes, and the end of Brexit in a good or bad way, we will finally have the chance to enjoy a more "normal" environment where the major events are not political elections, agreement on tariffs, central bank policies or European disputes, but simply the distribution of a medicine at a global level which will allow us to try to go back to a "normal" life".

Overweight Emerging Markets: this is the strongest view of the Committee. They will be the first beneficiaries of the pick-up in global growth and inflation, of the potential weakness of the Dollar and of an expected strong rebound in the price of commodities. **[Giovanni Matteucci (Lugano)]:** "We see the current backdrop as supportive for Emerging Markets, whose economies are being less impacted than Developed Markets by the ongoing second wave of Covid. Broadly speaking we believe both EM corporate bonds and EM FX should attract good inflows." **[Jacopo Turolla (Dublin)]:** "The recovery in the Chinese economy, which is likely to continue in the coming year, will support commodities on which many EM countries are dependent for Dollar inflows, boosting the asset class chances of positive returns on a spread basis." **[Carlo Morelli (Luxembourg)]:** "Reflation in commodity prices has started lifting prices of exporters (Nigeria, Angola, Kazakhstan, Ecuador). However, inflation prints are still at rock-bottom levels in most local markets and real yield support carry positions. Geopolitical risk is significantly improving and appointment of Antony Blinken as the US State Secretary bodes well for EM."

Recovery Fund: **[Karol Necki (Monaco)]:** "The final approval of the Recovery Fund would be a game changer for European periphery." Seeing the first issuance from this new common funding vehicle will be the "stepping stone to a more stable environment and all the liquidity will be deployed - another push to consumption and investments, which have the potential to boom mainly in the second half of the year".

Middle East: **[Faisal Ali (Dubai)]:** "We expect Middle East (ME) fixed income bonds to benefit from investor flows as ME fixed



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income provides high beta EM exposure. It offers spread pickup over other EM regions and we expect this differential to narrow in 2021. ME corporate and sovereign fundamentals should stabilize as economies rebound from lockdown. ... Within ME, we expect high yield (HY) corporates to outperform, especially issues from companies in sectors such as travel, tourism and commercial real estate – sectors which were heavily impacted by global pandemic."

[Abdullah Kunt (Istanbul)]: "We stay positive on Turkey hard currency sovereign bonds on supportive global monetary policies. ... They trade cheap to global peers and injection of global liquidity should be positive. ... Positive also on Turkish corporates, especially banks given that we are comfortable with their credit profile and their spread pick up over EM peers. We prefer AT1s and Tier 2 bonds."

Asia: **[Stefano Chao (Shanghai)]:** "We remain positive on China's economic outlook for 2021. By 3Q2020 both internal and external demands have defied expectations and we expect the trend to continue into 2021. ... From a foreign investor perspective, China rates continue to be attractive given historic spreads to USD/EUR/JPY coupled with inclusion in all three main global indices, inflows in the sovereign bonds could be considerable. ... We remain bearish on Chinese HY names especially in the industrial and real estate space while we are cautiously positive on the outlook for the IG space for 2021. ... Fundamentals for the Renminbi have never been stronger."

[Kuan Weng Pang (Singapore)]: "Asian government bonds are generally undervalued compared to US Treasuries. We think Indonesia government bond (IndoGB) should do well on a total return perspective, they are one of the cheapest in relative value terms vs other Asia sovereign debt. ... The Thailand Government Bond (ThaiGB) supply pressures are expected to remain benign in Thailand. ... South Asian credit premiums remain far wider than peers offering buying opportunities for quality IG names. ... Indian senior financial USD credit has seen spreads widening more than Chinese peers ... This gap in spreads presents an opportunity for quality Indian bank credit. ... Barring an acute USD rebound the carry trade that favors a basket Asia's highest yielding currencies (IDR, INR and PHP) against the greenback is likely to keep performing steadily."

Latin America: **[Geronimo Noriega (Mexico City)]:** "The recovery of the Mexican economy will be slower than in other EM countries. ... 2021 will present a good opportunity to have profits in credit mainly on Investment Grade names. ... In terms of non-IG issuers, we expect that some sectors that already posted hard discounts for example airlines, airports, tourism companies, transportation, non-discretionary consumption, leisure, and some financial companies may outperform IG issuers if economies recover better than expected. ... We believe the MXN will trade in a range of 19.60 to 21.50 MXN/USD."



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[Debora Nogueira and Laurence Mello (Sao Paulo)]: "Neutrality on government bonds should be the result of fiscal issues, the debt to GDP ratio and the lack of presidential leadership regarding the fiscal measures that are crucial for next the year. ... We are positive for Brazilian corporates in 2021. The main drivers are the resilient credit fundamentals, favorable external landscape and the progress on a vaccine roll out. ... BRL is now one of the cheapest currencies in valuation terms ... The political response to the fiscal issue is going to be crucial for the currency performance; if this doesn't happen then the BRL will probably keep underperforming its peers."

Investment Grade - Neutral: the spreads have been quite tight and the sensitivity to underlying interest rates has been the highest ever. It is still possible to find good opportunities – subordinated bonds, cyclical sectors – and the quality of the issuers is still good. But the probability of facing negative returns in a rising yield environment could be an issue. **[Andre Leao (Miami)]:** "About US IG, the spreads are very tight. Opportunities are rare, but these bonds make more sense than Treasuries. Themes to play in 2021: 5G, Fintech, Green Technologies."

Speculative Grade - Positive: we see room for further spread compression in HY credit driven by cyclical names, the biggest beneficiaries of the expected bounce in growth. **[Stefano Tirapelle (Milan)]:** "Subordinated debt, mainly AT1s, Hybrids and the flow of new issues in the HY space (LBO financing) could be cherry picking". More neutral positioning on US HY where spreads have been close to the bottom in the last few years and yields at minimum level; the focus should be on fallen angels outside the energy sector. **[Giovanni Sequi (Florence)]:** "We have a target of €20bn downgrades in High Yield and we think the default rate will remain contained, with a forecast of just 2%. We are expecting a record year for issuance driven by refinancing. In spread terms, EUR HY could experience another 100bp of compression."

Avoid or Limit USD Exposure: short-term rates are anchored both in US and Europe and real rates will remain negative, hence the USD volatility will remain relatively low. **[Giovanni Matteucci (Lugano)]:** "While we expect the USD to underperform the currencies more leveraged to the recovery cycle, mainly given their linkage to commodity prices, we see limited downside vs. the EUR". However, supply and funding dynamics could temporarily push the EUR toward a first target of 1.25. **[Geronimo Noriega (Mexico City)]:** "For the DXY Index (USD vs. a basket of global currencies) we expect it to remain within a floor of 88 and a ceiling of 94".

Trust Central Banks: **[Chiara Roccaro (Milan)]:** "Major central banks don't have any reason to act soon if the economy would eventually overheat, but they have good reasons to err on the dovish side and "risk" overheating both of growth and inflation."



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...after a bumpy Q1, because the flu peak season would probably cause a 3rd Covid wave, we expect a recovery of inflation due to base effect, but it won't go too far to trigger reactions from central banks; the vaccines will create a positive effect on sentiment and investment decisions, the labour markets will continue their steady recovery, the housing market will continue to add to GDP in US, with long rates moving higher but not in an uncontrolled fashion."

Italian Government Bonds: [Guido Casella (Milan)]: "The periphery will be sustained, and we see 10yr Italy/Germany spread below 100bps, hence Italian 10yr government bond will be almost stable with the shorter (5-7) part of the curve sliding slowly towards zero or lower maintaining the attractiveness of the 10yr maturity thanks to the steepness of the curve."

Other recommended trades: [Nicolò Bocchin (Luxembourg)]: "Buy Convertible Bonds - the fixed income instrument that provides a beta to equity markets with the protection of the bond-floor while limiting sensitivity to interest rates".

Negative Duration: in a normalising world with growth and inflation dynamics moving upwards and with the long maturities of government bonds probably moving higher in yield terms, negative positions on rates could make a difference within any portfolio. [Nicolò Bocchin (Luxembourg)]: "The Committee has a negative view on rates, both in US and Europe, not expecting dramatic moves which will threaten investors and derail the markets, but simply a "normalisation" trade finally happening". US will probably be the first region to get full vaccination. That combined with increased government debt issuance, better growth prospects and potentially a healthy pick-up in inflation (given declining saving rates + higher commodity prices + base effects) will probably generate higher back end rates and steeper curves. With GDP and inflation dynamics picking up, the 10yr TSY could reach levels between 1.35% and 1.5%. The yield curves of the European core markets are likely to follow suit albeit to a lesser extent, as growth/inflationary pressures and European government bonds demand/supply dynamics make the case for higher/steeper curves less compelling. The steepening movement would be related to the evolution of European inflation which should in any case move higher taking the yield on 30yrs maturity bonds back to a positive yield.



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