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Q&A-Risk assets set for positive 2021, Asia to lead post-COVID-19 recovery; Hunt for yields to continue: Neeraj Seth, BlackRock

The overall backdrop for risk assets will remain positive in 2021, supported by easy money from central banks, with Asia well-poised to lead the post-COVID-19 recovery, **Neeraj Seth, head of Asian Credit at BlackRock, which manages a record $7.8 trillion in assets, in Hong Kong,** told the Reuters Global Markets Forum on Tuesday, December 1.

Investors will continue to look for income, yields and returns, he said.

"Hence, countries with reasonable fundamentals and good growth potential (will be preferred)," Seth said at the Reuters Global Investment Outlook Summit, 2021.

Following are edited excerpts from the conversation:

Q: How does the overall backdrop for risk assets look, especially with vaccine news clashing with lockdowns 2.0?

A: Overall, the backdrop for the risk assets remain positive, and I think it's built on a combination of the policy response that we have seen over the course of last six-to-nine months, the expectations looking forward in terms of the reopening of economy, and to some extent, the support from the vaccine that actually provides that bridge to the economic activity resuming in the world. So, when you put that all together, I do still think there are some risks that we have to be mindful of which includes some of the recent lockdowns. It also includes the ongoing geopolitical uncertainties. That's something which has gone somewhat in the background for now or are expected to go in the background. And you do see some news flow around the U.S. sanctions on some of the Chinese names and the broader noise around that. As we go through the shift in the U.S. market, we'll reassess that risk. But overall, you just have to be mindful of it. I don't see it as a base case scenario of any meaningful increase in that risk. But with U.S. election risk out of the way, and the other aspects that we touched on, I do think the overall markets are very well placed going into 2021 from a risk-asset standpoint.

Q: When do you expect policy measures introduced by central banks to be unwound and would it be gradual?

A: If you look at (the) combination of growth, (economic activity to resume), inflation (to start inching higher) and employment (to come back to what you typically would define as the full employment level), and in terms of the output gap where we are, I think it still will take another 12-to-18 months before we get there. Now, taking that backdrop, if I think about the policy measures from a monetary perspective, from a central bank side, I don't think that we are anywhere close to the shift in the monetary policy in most parts of the world, at least not in 2021.

Last part I would say is more specific to the U.S. policy. I do think we have seen a shift in 2020. From a broader policy framework standpoint in terms of the Fed moving towards the average inflation targeting (AIT). And I think it's amply clear, if you listen to the Fed speakers, that they would like to see the inflation, not just reach 2%, but sustain at 2% or higher level, before they move towards the tightening measures. And needless to say, for the U.S., and a lot of developed markets, the first step would be to actually taper the QE (quantitative easing) before you go into the rate hikes. So, when you put that together, I think the rate hikes are certainly not in the near horizon on any of these economies.

Q: So, the 2%, that target remains pretty much a line in the rock, not so much in the sand?

A: Yeah, and it's different than the history because historically the Fed would look at the inflation and inflation expectations. And as you are getting closer to 2%, they would start to tighten up. Now they would like to see it sustain above 2%, because over the last 12 years since 2008 crisis, it has been very few times that we have seen inflation sustaining about 2% in the economy. So, I think there's certainly more time it will take to get there.

Q: Does the rollout of vaccines and post-pandemic world see a bigger gap between the have and have-not countries, opening a fissure between the developed and developing economies?

A: I think the vaccine -- depending on distribution and availability -- if anything, from a country perspective, reduces what you typically would define as the haves and have nots. But where you do see and expect to see differentiation is going to be based on the relative fundamentals going forward. So, the point is that yes, there will be differentiation. But that differentiation is not driven by vaccine. It's driven by the fundamental trajectory of the economies and the sovereign balance sheets when you look forward. We have seen certainly some level of that differentiation in the last six-to-nine months, and now I think that will continue. One thing which is very, very important to highlight is, as we look forward, and as the dust starts to settle down post the COVID-19 shock in the next year or so, what we are seeing is the world with a lot of debt and a lot of low-yielding debt.

We see the growth potential, obviously, which looks a little more challenged from a global perspective. And hence, the investors will keep looking for income, yield and returns. So, I don't think that is going away, that's only going to get more amplified. Countries with reasonable fundamentals and good growth potential -- that remains a positive backdrop wherever you find that. The vaccine only, in fact, helps in certain ways for the reopening of these economies and getting the growth back on track.

Q: What would those countries be, from what you can see and probably project?

A: If you start from a regional perspective, I think overall, Asia is very well placed. And you can look at the data. So, if you look at the 2020 growth expectation, Asia overall has the least amount of contraction relative to the rest of the world from a regional perspective. If we look forward, the expectations of growth in 2021 and beyond (in) Asia, the growth differential relative to rest of the world also looks actually quite positive. And then within Asia, you have a combination of countries like North Asia, where you have seen a meaningful recovery post COVID-19; So, China, Korea, Singapore. And then you have countries with reasonably strong growth potential and some early signs of strong data coming out; So, Indonesia, Vietnam (and) India, to some extent where the recent set of data has been positive.

I do think you have certainly a strong case for countries where you expect the fundamental just to come back to a stronger path, and then the growth to actually resume, so there's a case for a number of these countries, I would say China certainly stands out in that context in terms of this, the overall rebound, and the strength of the economy post COVID-19.

Q: How do you expect yields in developed and developing markets to behave in 2021? Any strong trends emerging?

A: It's interesting because (the trends) will vary by country. So, you will have some divergence, specifically when you think of the government bonds. And we certainly do expect to see potential for some backup in the U.S. treasuries to slightly higher levels for the resumption of economic activity and growth coming back. Whereas in Europe or Japan, I don't think we expect a lot of shift in the yields going into next year.

Whereas coming back to Asia, I still believe that few of the countries like Indonesia, India, potentially Malaysia -- there's still room for monetary policy easing from the central banks, and hence yields can drift lower, at least in the next year horizon. Whereas in case of China, we expect the monetary policy to stay on the sideways path -- so stable. But the bond (price) needs to potentially drift lower as some of the technical factors which are pushing the bond yields higher over the course of last six months have started to soften.

(In India) you will still see some possibility of the central bank to ease further. So, you're in base case scenario looking at some of the Asian countries to be on neutral to accommodative path in 2021.

Q: Would you have an approximate band for the U.S. 10-year yield by Dec. 2021?

A: I'll give you a slightly wider range -- I think it probably is somewhere in the range of 1.00%-to-1.50%. And where you are by end of December is going to be a function of the economic activity, the trajectory of inflation, unemployment and expectation from the standpoint of the Fed with regards to the overall policy mix between the QE and the monetary policy in terms of the rates, where the market pricing is at that point. And that will depend on how the data looks like over the course of next six to 12 months.

Q: Will inflation now be unleashed as many suspect? Where does it show up, and if not, what happens next?

A: This is an interesting debate that the world obviously is going through looking at the history. And right now, if I look at where things are, in the near term, let's say in the next 12 to 18-month horizon, I don't think there's a lot of risk of inflation. And that's more driven by -- just by virtue of where the output gaps are. And till the time you cover those output gaps and the unemployment levels actually reduce, the risk of inflation coming unless it's a supply driven inflation or supply shock driven inflation, I don't think you have a higher risk of inflation. But as we go down a couple of years, given the combination of the monetary policy, the fiscal, and equally importantly, the broader concept of deglobalization with the shift in supply chains, which is not going to happen immediately, but as a longer term trend, you would potentially see some uptick in inflation.

But on the other hand, you still have the combination of debt, demographics, technology, which have been and will remain disinflationary forces in the world. So, I think it's a bit more balanced. Which, in my view, tells me at least you do see inflation, do we see a risk of higher hyperinflation? I am not 100% sure about that. I don't think that's the case. Some modest pickup in inflation, I think, is what you would expect down the road.

Q: How do you see demand cycle picking up in the coming quarters while we keep our inflation target flat?

A: The only thing to add is that the demand cycle, as you can imagine, is going to keep picking up gradually as the economy opens up, and as people feel more comfortable in terms of consumption. So, depending on the country, you would see savings rates moving higher, and some of that normalizes over the next 12-to-24 months. But you have enough room on the supply side of the equation, that I touched on through the output gaps, that's not an inflationary impulse. That's actually a positive for the economy.

Q: How does ESG and climate change affect portfolio allocations for investors? How much does it figure in your portfolio?

A: That's an interesting question because overall ESG (environment, social and corporate governance) is an area which has been gaining importance over the last few years. And I would say that focus on ESG, from a global investor perspective, has accelerated in the last 12 months. And some of these trends which were in the play have accelerated, and it's not necessarily a direct impact of COVID-19 per se. But certainly, some of it has happened. And if I look forward, I would say overall, ESG is going to become more and more important part of the portfolio allocations and investing and, in fact, for us it's very much an integral part of our investment process. And I think that's the direction of travel the world is going towards. So, whether it's at a country level or a company level ESG is something which is going to be very important in the coming years and decades.

Q: What's is your view on the debt of Chinese state-owned enterprises (SOE), especially with a large amount of maturities coming up in Q1CY21?

A: This is an important topic over the course of last four weeks or so now with some of the high-profile defaults that started to show up. And thinking about what's really going on -- in my view, I think when I look back the last decade, and most of the last five years, the growth in the capital markets in China started only somewhere in 2012-2013. The first default happened in the June of 2014. The deleveraging focus started in 2016. But the initial set of deleveraging focus that China had was very much on the financial sector deleveraging. Now what's going on as the economic activity has come back fairly strong growth trajectory post COVID-19, you're to see a focus shifting towards the SME (small and medium enterprises) sector as a whole. So overall, I would say this is more of a natural progression in terms of the regulators and the government focus on the leverage in the system. And in some ways, the second chapter of deleveraging. So that's something which is and will remain relevant in the next few years. But at the same time, it's not a systemic risk.

Q: What are your top risks for 2021?

A: What I said (earlier) in terms of the overall actual impact of lockdowns. So, how quickly the current economies are able to come back, and geopolitics. I think the key is, we are going to enter a new era of the geopolitics with the change in administration in Washington. So, you just have to watch closely in terms of how that evolves further. I'm not sure if I can categorize as softer or harder, I can categorize as a different way. The broad foreign policy aspect, certainly there will be some areas of tension in the relationship potentially. But I think overall, (it) will go to the traditional way of what we are used to in terms of managing foreign policy.