FIXED INCOME DEVELOPED MARKETS

Global liquidity, US outlook, and politics are the key drivers

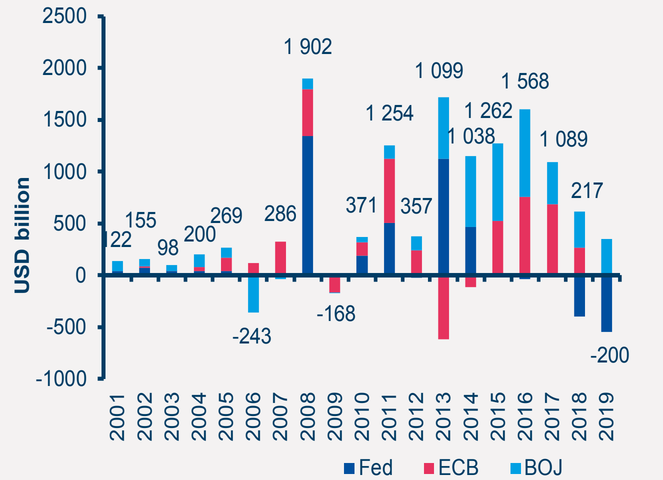
The essential

The US economic outlook, the global liquidity cycle, and politics will be the main drivers of fixed income markets in 2019. In the US, we expect the strong growth to moderate over the next few quarters, determining the end of the Fed's tightening cycle and limiting the rise in US bond yields. Geopolitical risks could weigh on both global growth and overall risk aversion in the market. This could push core bond markets' yield downwards. The safe-haven status of the US treasuries/USD and Bund markets may be noted. The combination of an increase in the US debt supply and reduced central bank liquidity injections will play a role in determining technical factors, both for sovereign and corporate bond markets. In this environment, investors should increase duration, especially in the US, as a defensive strategy, and reduce the overall risks in their portfolios. We remain cautious on Eurozone peripheral issuers, and very selective on credit, where valuations are tight, especially in lower-rated US HY.

Contrary forces at play on core bond yields: watch the US outlook, the Fed and global liquidity

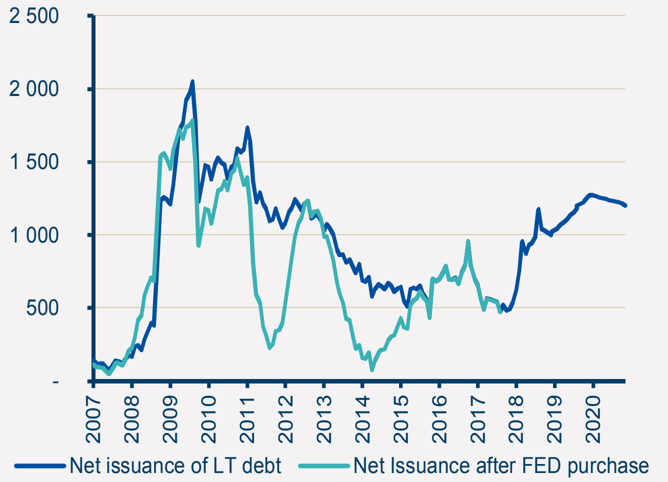
- **The expected deceleration in US growth in H2 2019 and contained inflation pressure should limit the rise in long-term rates in DM.** In the US, we expect the Fed to deliver another hike in December 2018, two hikes in H1 2019, and then to stop its monetary tightening cycle. On their side, Federal Open Market Committee members are showing increased uncertainty only around 2020-2021 economic prospects. A scenario with higher long-term rates would require that: (1) the US economic expansion could be sustained for a longer period, with no strong pressure on inflation; or (2) an inflation spike. We see limited probability that either of these two conditions will materialise, and think any further upside on US bond yields, induced by some pressure on wages, could be short-lived and limited. In Europe, long-term rates are set to bottom out, with the end of the ECB's quantitative easing and the first interest rate increase (though not before September 2019). We also expect the uptrend in long-term rates to be limited, as the ECB will remain very gradual in the removal of its accommodative measures.
- **Less and less favourable technical factors should push for higher rates and wider spreads, but also have a negative impact on global growth.** In 2019, the net liquidity injected by CBs in DM will turn negative. At the same time, US debt supply will jump to fund the US administration's expansionary policy and the maturing debt of the highly-leveraged American companies. Non-resident investors have provided huge support to the US dollar corporate bond market in recent years, but the context has changed: huge hedging costs have reduced the interest of Eurozone and Japanese investors in US assets. In Q2 2018, Eurozone investors cut their net holdings of US debt securities for the first time in four years, and Japanese holdings of US treasuries are at the lowest levels since 2011. As such, the massive rise in US funding needs is likely to be satisfied by dollar investors at the expense of EM. Consequently, the higher US debt supply could push for higher rates, but as this could increase the downside risks to the global economy, we expect limited upside

1/ **Central bank balance sheets**



Source: Bloomberg, Amundi Research

2/ **US: net issuance of US treasury securities (12m. rolling sum, USD bn)**



Source: Bloomberg, Amundi Research

pressure on US bond yields. In Europe, despite the end of new QE purchases, technicals will still be partially supported by robust volumes of ECB reinvestments and by a very gradual approach the central bank is likely to follow in normalising rates.

Key investment convictions on fixed income and credit markets for 2019

The potential for increasing US rates is, in our view, limited by several factors: 1) the strong demand for US treasuries by US dollar investors; 2) the downside risk associated with the global growth scenario (the sensitivity of emerging markets and global growth to US rate levels); and 3) the mature phase of the US cycle. In the Eurozone, the ECB is going to be cautious on rate hikes, and risk aversion will likely remain high. As such, we expect limited pressure on interest rates.

Under the scenario of limited rises, we predict the following:

- **In US: In H1 2019** interest rates should stabilise or increase only slightly, as we expect 10-year yields to peak near the expected peak in Fed funds. In this scenario, the 10-year yield would remain around current levels in the coming months and the US curve would only slightly flatten. In terms of curve segments, therefore, the short to medium segment would still offer an attractive risk/reward combination versus the long part of the curve. **In H2 2019**: we see some slight downside risk on bond yields in the second part of 2019, together with the slowdown in US growth and the Fed reaching its target on rates normalisation.

10Y bond yields - Dec 2019	
	Target range (%)
US	3.1/3.2
Germany	0.55/0.75
Japan	0.1 / 0.2
UK	1.7/1.8

Data as of 15 October 2018

- **In Europe**, the ECB is likely to stick to its cautious forward guidance on rates: the first hike is projected to be delivered not before Q3 2019, and a long period of reinvestments (two-to-three years) should follow: this very gradual approach will be data (and trade issue/political risks/impact on oil prices on EUR) dependent. The ECB will have to carefully assess the timing of the first hike in interest rates as this could happen when the Fed suspends its monetary cycle and the Euro strengthen, potentially leading to excessive tightening in financial conditions. In addition, despite the positive-growth picture, risks are persisting on the political front (Italy, European elections, Brexit). For these reasons, we expect 10Y Bunds to rise but in a limited way. A dovish ECB keeps the search for yield alive in the two to five-year curve bucket, the segment in which Italian spreads also offer more space for normalisation in case of an earlier confrontation with the EU.
- In an environment such as that we have outlined, investors could consider hedging fixed income portfolios from the persisting **inflation risk**.
- **Credit markets** offer a mix of still generally supportive fundamentals but more negative technicals, while valuations differ more significantly between the US and the Eurozone and between high grade and speculative grade. Leverage, valuations and non-resident investor support are more challenging in the US. Here, some diversification towards structured credit sectors, including agency MBS as well as non-agency MBS and ABS, may offer more attractive relative value to investors. Political risks and less brilliant macro growth, together with the end of the Corporate Sector Purchase Programme (CSPP), represent major challenges for European corporates. At the same time, valuations look generally more stretched in high beta USD denominated bonds, where the risks of market complacency are higher in case of negative surprises on economic trends and tightening financial conditions. Preference goes to high grade, low duration corporates in the US, and to a more tactical approach on Euro HY and financials, depending on the evolution of political risks, while core names keep their resiliency.

In conclusion, the environment above calls for an active and tactical approach in global fixed income for next year. The short duration stance, which has characterised most of 2018, will be replaced by a more constructive view on duration (neutral in the US), which also acts as a hedge to global risks. On credit, improve the quality will be key. Sector rotation in a wide spectrum of fixed income assets and diversification in the credit continuum space (liquid and illiquid assets/private debt) could help to create value for investors. As global liquidity is set to shrink, we could see episodes of market liquidity deterioration. Therefore, a focus on liquidity management will be key to potentially grasping the opportunities that should open up during the year.

Positive triggers	Risks to monitor
• Easing political risk together with an eventual soft Brexit deal would support a recovery in periphery and corporate bond spreads in the Eurozone	• In the government bond area, positive surprise in inflation/growth in the US and/or a policy mistake (a too fast retreat from QE by the ECB or BoJ), could drive interest rates higher
• A deal between China and US on trade would result supportive for global and US credit and also for Eurozone spread segments	• In the Eurozone, persisting and increasing political risk would weigh on periphery countries and corporate bonds, despite the limited contagion so far
• In the government bond segment, risks on growth and/or on the geopolitical side, would support the search for safe haven	• In credit markets, risks come from a sudden and unwanted tightening in financial conditions linked to a negative surprise on growth, especially in the US where leverage and debt is higher

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2019 Outlook Special Issue

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