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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

ECB: Short term rates anchored

Didier BOROWSKI
Head of Macroeconomic Research

Eric BRARD
Head of Fixed Income

KEY INSIGHTS:

- ***ECB tone:*** *The European Central Bank announced the end of the asset purchasing programme for year-end but introduced a commitment to leave rates unchanged until the summer 2019, so anchoring the expectations of low rates for an extended period of time.*
- ***Economy and risks:*** *The ECB growth scenario is in line with our expectations (we expect slightly lower growth next year, at 1.8%). Risks have increased (trade tensions, oil prices, economic-policy uncertainty in Europe) but have no reason to derail the current expansion. On the inflation side, the ECB projections have been revised up, indicating that second round effects, i.e. a mini wage-price spiral, could materialise.*
- ***Market implications on European fixed income:*** *The ECB has reinforced the anchoring of the short maturities and the directionality of the curve. Upside surprises on growth and/or inflation should impact the longer maturities and translate into a steeper curve. In corporate markets we keep a cautious approach, but the strong fundamentals and the widening of the spreads is opening selective opportunities. For peripheral markets, the current rate environment should favour spread tightening, according to the specific fiscal positions.*
- ***On currencies and global fixed income:*** *With the normalisation of monetary policies, specific situations in EM countries and the rise in geopolitical risk, currency volatility will remain the name of the game and will continue to open opportunities on the currency market. Monetary policy divergences, also visible in the last CB meetings, create investment opportunities both on currencies and on bonds. We could expect a further widening of the spread between US and core Euro yields.*

What are the main takeaways from the ECB Governing Council meeting?

Borowski: First, on monetary policy:

(1) Starting in October, the monthly pace of the Asset purchase programme (APP) will be reduced from €30 bn to €15 bn; and it will stop at the end of the year.

(2) The ECB maintains its policy of reinvesting the principal payments from maturing securities (purchased under the APP) for "an extended period of time after the end of the APP" (i.e. after the end of the year).

(3) Key interest rates will remain unchanged "*at least through the summer of 2019*".

Regarding (1) and (2), the decision was very much in line with the spirit of what the ECB had already communicated to markets on several occasions. Only the details (monthly pace of the APP in Q4 and the timing of the announcement - June or July) were really in question. Concerning (3), the tone is slightly more accommodative; the ECB clarifies its plan: instead of saying that key rates will stay unchanged until *"well after"* the end of the APP (which was somewhat ambiguous), the ECB now prefers to indicate a more specific time frame: there will be no rate hikes through the summer of 2019 at the earliest.

The objective is clearly to anchor the expectations of low rates for an extended period of time in order to *"maintain the current ample degree of monetary accommodation that will ensure the continued sustained convergence of inflation towards levels that are below, but close to, 2% over the medium term"*. Actually, given the ongoing recovery and the projected rise in inflation, by doing nothing the ECB would have implicitly further eased the degree of monetary accommodation, which was really not desirable. The end of the APP (which could have been perceived as a negative signal by markets) is counterbalanced by the enhancement of the forward guidance. In addition, Mario Draghi emphasized the fact that asset purchases remain available in the ECB toolkit, if needed.

Second, on the underlying **economic scenario**, the ECB:

- revises down its GDP forecast from 2.4% to 2.1% (2018), keeping unchanged its real GDP forecasts for 2018 and 2019 (resp. 1.9% and 1.7%)

With the contribution of

Valentine AINOUZ
Global Aggregate Strategist

Laurent CROSNIER
Head of Global Alpha Fixed Income

Cedric MORISSEAU
Head, Absolute return, GFI

Alexandra VAN GYSEGHEM
Head, IG Credit, Euro

Isabelle VIC-PHILIPPE
Head of Euro Govies and Inflation

- revises up its headline inflation forecast from 1.4% to 1.7% (2018 and 2019), keeping unchanged its forecast for 2020 at 1.7%.
- keeps unchanged its core-inflation forecast for 2018 at 1.1%. But slightly revises up its core-inflation forecasts: from 1.5% to 1.6% (2019), and from 1.8% to 1.9% (2020)

According to the ECB projections, the GDP expansion will remain above potential for the next two years, driven by both domestic investment and household consumption. Inflation is revised up, albeit modestly.

What macroeconomic developments in the Euro area motivate the current ECB stance? Is the inflation pick up sustainable and do you see the recent weakness in GDP growth as temporary?

Borowski: Concerning growth, the new ECB scenario is in line with our expectations (we expect slightly lower growth next year, at 1.8%). Risks have increased (trade tensions, oil prices, economic policy uncertainty in Europe) but have no reason to derail the current expansion. Indeed, the cycle has not matured yet. The recovery remains driven by both (1) domestic investments (thanks to rising profits, higher demand, high capacity utilisation and supportive lending conditions) and (2) household consumption (thanks to low interest rates and rising household wealth).

The recent weakness reflects *"a pull-back from the very high level of growth in 2017, compounded by an increase in uncertainty and some temporary supply-side factors"*. Looking ahead, GDP growth is expected to decline because the impact of past monetary policy measures will gradually decline (gradual dissipation of tailwinds). But the most important thing is that, despite the slowdown, GDP growth will remain above its potential in the coming two years and, against this backdrop, the unemployment rate is expected to decrease further (from 8.3% in 2018 to 7.3% in 2020 according to the ECB forecasts).

On the inflation path the ECB is more confident than we are. The upward revision to headline inflation is mainly related to oil prices that are much higher than in Q1. But the upward revision to core inflation in 2019 and 2020, albeit modest, is more surprising: the ECB factors in second-round effects. Unit labour costs are rising at a faster pace on the back of higher nominal wage growth (due to tighter job markets) and also to some extent to lower productivity growth this year. As a result, with some lag, the ECB foresees that core inflation will increase a little bit more next year. The revision is modest but indicates that a mini wage-price spiral can materialise: a clear indication that the risk of deflation has disappeared. Having said that, we have to keep in mind that the pricing power of firms is quite limited (more than in the US) and that core inflation is likely to remain subdued in any case.

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On the political front Europe appears afflicted by domestic concerns (Italy *in primis*), increasing tensions on crucial issues (immigration) and in the spiral of a global protectionist escalation. What are the future crucial events to look at? Where do you see the major risks?

Borowski: It's all about uncertainty in several areas at the same time. The protectionist measures announced by Trump weigh on confidence. The G7 summit shows that Donald Trump is ready to go further (he explicitly threatens to raise tariffs on imported cars from Europe). The likelihood of a tougher trade confrontation is increasing, at a time when geopolitical risks in the Middle East remain elevated (with upside risks on oil prices). These are clearly major risks to monitor closely, as they can affect the global outlook.

With the new government coalition between M5S and the League in Italy we can expect more tense relationship between Italy and other EU countries, particularly when it comes to the fiscal and migration policies. However, concerning the former, the first statements of the Finance Minister are intended to reassure its partners in Europe: it is out of the question for the coalition to implement a policy that would put at risk Italy's euro membership. This is why the coalition has postponed (to 2019 or 2020) many of the fiscal measures that were initially planned in its programme. In the short run, it is clearly the migratory crisis more than fiscal policies that threatens the most the EU cohesion at the very moment when cohesion is needed to complete the monetary union and strengthen the EU (defence).

Mario Draghi's last words in his introductory statement were meant to send a warning signal: *"the Governing council urges specific and decisive steps to complete the banking union and the capital markets union"*. The message is clear: the ECB has done its job. The ball is now in the camp of EU governments. All eyes are on the next European council (28-29 June 2018) with the agenda including migration ("finding solutions to migratory pressures") and the reform of the economic and monetary union. On the migratory crisis, it's hard to be optimistic. While on the strengthening of the financial architecture, Angela Merkel has recently opened the door to a timid compromise on the transformation of the ESM bailout fund into a European Monetary Fund (EMF), provided national governments have sufficient oversight. No doubt that such an institution would intervene with strict conditionality (as the IMF does): it would be a clear incentive for the Italian government to respect its fiscal commitments.

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How is the liquidity evolving in the European bond market, what could be the consequences of the end of QE in this context?

Ainouz: The end of the QE could be challenging for different reasons:

(1) Growth in the Eurozone is decelerating. Rising risks also weigh on our scenario, including trade tensions and the price of oil.
(2) The peak of liquidity is behind us. At the global level, net issue volumes of government bonds will no longer be absorbed by CB purchases as in the last three years. In the coming quarters, the Fed will continue to reduce the size of its balance sheet while increasing the supply of US treasuries. In contrast, the monetary policies of the ECB and the BOJ were extremely accommodating at the time the Fed stopped its QE.
(3) ECB QE was huge in respect to net debt issuance. In the euro area, purchases by the Eurosystem were significantly larger than new net issuance. ECB purchases have been up to 5 times net issuance. By contrast, purchases of US government bonds never exceeded their net issuance.
(4) Eurozone political concerns are back.

The end of the program could increase the volatility on the markets and contribute to some repricing of risk premiums. The asset purchase program (QE) has given considerable support to the markets by reducing the tail risk and weakening the euro in recent years. At the same time, the dovish outlook on interest rates will continue to support the search for yield. Today almost 25% of the Euro Fixed Income market is trading at a negative yield. The ECB expects the key interest rates to remain at their present levels at least through the summer of 2019. The yield on the short part of the curve will remain anchored by the forward guidance. The ECB is not in an easy situation. It is worth noting that the Fed is normalizing its monetary policy in a very different environment.

Upside surprises on growth and/or inflation should impact the longer maturities and translate into a steeper curve.

What is your view on European interest rates in light of the recent ECB announcement and of the multiple risks at the horizon?

Vic-Philippe/Van Gyseghem: The ECB achieved two objectives: to announce the end of the buying program while reinforcing the forward guidance on interest rates and to take into account the current moderation of growth. It removed the possibility of increasing rates before summer 2019. This reinforcement of forward guidance has to be considered in light of the revised forecasts on headline inflation at 1.7% from 2018 to 2020, while core inflation is forecasted at 1.9% in 2020 so very close to the ECB target.

All in all, the ECB has reinforced the anchoring of the short maturities and the directionality of the curve. Upside surprises on growth and/or inflation should impact the longer maturities and translate into a steeper curve. The ECB is acknowledging the uncertainties that have arisen on economic activity from geopolitical tensions or domestic bottlenecks.

In corporate market we keep a cautious approach, but the strong fundamentals and the widening of the spreads open selective opportunities.

Do you see value from the recent weakness in corporate market and which segments? Or is it time to be even more cautious on credit?

Vic-Philippe/Van Gyseghem: Caution is still key in the current market although credit spreads have stabilized. Italy's risk is well and truly present, global trade war is also representing a risk. However, we expect the sell-off to slow, as spreads are significantly wider now. If they continue down this route, we believe credit will eventually become very attractive once again. The CSPP will be standing as a large support with reinvestments continuing long ahead after the end of the CSPP. Fundamentals remain also strong. The level of cash is still high in corporates balance sheets; lastly, share buy-back programs also support the market. Despite the above factors, strong capital ratios and the recent widening of the spreads, investors should be cautious on the financial sector, and especially on the highly subordinated and long dated banking sector; we prefer high beta short dated bonds which provide a large carry and are less sensitive to rising interest rates. Investors could also benefit from selective issues on the primary market which has been repriced, thus providing larger new issue premium. To conclude, despite being more cautious on the credit asset class, we still find value on the 3-7 maturities corporate bonds.

What do you think about peripheral bonds, and do you see relative value opportunities across peripheral countries?

The current rate environment should favour peripheral spread tightening. The Italian debt cheapened significantly, but a rebound will much depend on the evolution of the fiscal policy.

Vic-Philippe/Van Gyseghem: This rate environment should resume peripheral spread tightening; the better the fiscal position of the country, the bigger the spread movement. If Italy manages to engineer adequate fiscal expansion within the euro zone framework, markets could behave favorably as they did with Portugal in 2016/2017. For the latter, the initial skepticism turned into a positive assessment, unleashing real growth without significant fiscal slippage. For Italy, we will get additional clues on the fiscal evolution with the next budget proposal in autumn. In that respect, the short term section of the Italian curve has suffered significantly and could be the first to react to positive events. In the meantime, other peripheral countries should see their spreads tightening back to pre-Italy turmoil.

What is your main concern on global fixed income markets? How are you addressing it?

Crosnier/Morisseau: Our main concern is capital preservation in an environment of low yield, future rate hikes and an increase in market volatility. The first way to address it, is to protect portfolios against hikes in interest rates through underweight/short in modified duration and to build a well-diversified pool of spread sources (credit, EM, securitized bonds), and in Tips.

Do you think the higher volatility regime on currencies is there to stay? What opportunities can investors play on currencies?

Crosnier/Morisseau: With the normalisation of monetary policies, specific situations in EM countries and the rise in geopolitical risk, currency volatility will remain the name of the game (and it should be the case for all assets, coming along the monetary policy normalisation from the main CBs). Volatility is risk but creates investment opportunities for smart investors, through selective longs views in front of well selected short views. Approach on currencies will be directional views (long $/short £; long rub/€) but as well relative value (nok/sek; aud/nzd).

Do you see opportunities arising from the divergences among developed markets in rates and currencies?

Monetary policy divergences also visible in the last CB meetings create investment opportunities both on currencies and on bonds.

Crosnier/Morisseau: Yes, clearly the latest FOMC was hawkish confirming the current stance of the FED and the confidence of the strength of US growth. At the same time, the press conference of the ECB, was pretty dovish (compared to market expectations), highlighting the slowdown in growth as well the rise of external risk factors. This creates investment opportunities both on the currencies side, and on the bond side. We could expect a further widening of the spread between the US and core Euro yields, and divergence in terms of yield curves dynamic. Nevertheless, the ECB decided to reduce its bond purchases, which should limit the appetite for euro govies bond market. Concerning currencies, this last call from the Fed is clearly USD supportive. The trick is to avoid to double the position between bonds and currencies but to provide true diversification.

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