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Amundi
ASSET MANAGEMENT

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INVESTMENT TALKS

The Fed leans hawkish and short rates move higher

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- ***Monetary Policy**: The financial markets were expecting a hawkish Federal Open Market Committee (FOMC) and the Federal Reserve delivered. As expected, the Fed hiked the target Fed Funds rate by 25 basis points (bps) from 1.75% to 2.00%. In addition, as was flagged in the May minutes, the Fed hiked the Interest on Excess Reserves (IOER) by 20 bps to 1.95%, describing it as a "minor technical adjustment" so that the Funds rate would trade well within the target range. The balance sheet normalization caps will increase, as planned, to $40 billion per month beginning in July.*
- ***Fixed Income:** The hawkish FOMC statement and the press conference indicate upward pressure on US fixed income markets should continue. At the same time, the Fed may have to respond if the Treasury yield curve continues to flatten. We do not believe the Fed wants an inverted yield curve, but the addition of the "symmetric" language regarding inflation, discussed below, may have complicated the situation.*

Fed Funds rate closer to neutral; better GDP growth and inflation cited

The Fed's projection of future interest rates – also referred to as the "dots" – pulled forward its hikes by 25 bps, increasing from three rate hikes to four in 2018, maintaining three hikes in 2019 and moving from two to one hike in 2020. The longer run estimates remain unchanged. Accompanying this move were some notable changes to the FOMC Statement:

- First, the Fed amended forward guidance to remove the language characterizing the current target rate as "likely to remain, for some time, below levels that are expected to prevail in the longer run." This indicates that the Fed believes it is moving closer to its neutral Fed funds rate, which carries a mean projection of 2.9% – a level where real GDP is growing at trend and inflation is stable. Interestingly, Fed Chairman Jerome Powell indicated in his press conference that expansionary fiscal policy might push up the neutral rate modestly.
- Second, the economic outlook was upgraded, reflecting momentum in consumption and strong labor market conditions. As a result, the Statement of Economic Projections (SEP) raised the GDP forecast from 2.7% to 2.8%, while the unemployment rate forecast was lowered from 3.8% to 3.6% in 2018. Incidentally, the unemployment forecast was lowered by 0.1% in 2019 and 2020.
- Third, the Fed injected the word "symmetric" into its inflation discussion, presumably to warn markets not to react to a near term overshoot in the Fed's PCE (personal consumption expenditures) core target due to higher oil prices. The "symmetric" language indicates that a deviation in inflation to the upside or downside of the Fed's 2% target will not necessarily elicit a policy response. The Fed raised its inflation projection from 1.9% to 2.0% in 2018, but kept it unchanged for 2019 and 2020. We believe the Fed did itself some injustice, since the market reacted by flattening the yield curve, which is probably not what they intended.

The Fed is focused on the US, vs. international risks

The Fed is focused on the US and is not concerned about the Euro, the impact of a populist Italian government, or the risk of a sell-off in emerging markets. Interestingly, the statement made no reference to international risks, such as increased volatility in emerging markets and a potentially unstable political environment in Italy. Furthermore, when pressed on the impact of trade wars on the US economy, Chairman Powell indicated that the FOMC has not seen signs of any adverse impact of trade on US GDP growth. Powell stated that trade policy stood under the purview of the executive branch, and that the Fed had no impact on such policy.
These views suggest the Fed remains more focused on the still easy financial conditions in the US, and that the volatility in global financial markets, especially emerging markets, represents

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a natural fallout from the global normalization of central bank policies. While the Fed under Chairman Yellen acknowledged global risks in early 2016 as a contributing factor in its decision to defer rate increases, it is unclear whether global factors would exert as significant an impact on the current FOMC. It appears that this FOMC is primarily focused on US GDP growth, which has increased markedly in response to the tax cuts, decreased regulation, and higher government spending.

Monthly press conferences intended to increase flexibility

The Fed press conference schedule has changed. Chair Powell is moving to monthly press conferences beginning January 2019, indicating increased flexibility. This move is notable because it signals that every meeting will be "live". This change reprograms markets to price in potential rate changes on a monthly rather than quarterly basis, providing greater flexibility to the Fed as it approaches the neutral Fed funds rate.

Broad market outlook

Moving towards reduced global liquidity

We believe we are facing a period of reduced global liquidity, which is being ushered in by the US taper of its balance sheet, and will accelerate as the European Central Bank (ECB ends its purchase program at year-end. In addition, the Fed's rate increases have contributed, at the margin, to tighter financial conditions, although high yield credit spreads remain well below long-term averages. In such an environment, any concerns about global growth that may arise as a result of concerns about an Italian exit from the Euro, or from emerging market stress, may have a more significant negative impact on investor sentiment. In addition, we are witnessing excesses in certain credit markets, including bank loans and investment grade corporates. As a result, we have become more cautious in terms of our exposure to higher risk assets in general. We are increasingly cautious of exposure to corporate credit, as well as to emerging market currencies. We are more constructive on US-centric assets and lower risk assets, including Treasuries, as yields have risen, as well as agency and non-agency MBS (Mortgage Backed Securities).

We believe Treasury yields will rise by year-end

By the end of 2018, the 10-year Treasury may trade at a yield between 3% and 3.5%, assuming a 2.4% Fed Funds target rate. Typically, the 10-year may trade 100 bps higher than the neutral Fed Funds rate. Longer term, the Fed estimates a neutral Fed Funds rate of 2.875%, but as Chairman Powell discussed, the FOMC has a wide range of estimates, from 2.25% to 3.50%. We would tend to favor the lower end of that range, so we believe that the 10-year Treasury yield will not increase markedly beyond our year-end 2018 estimate.

Investing in the current market

Interest rate positioning: short duration and moderation in yield curve positioning

For fixed income investors focused on short- and intermediate-term bonds, we continue to favor a relative short duration position compared to benchmarks indices. Our view is that inflation may exceed market expectations. However, as the Fed has indicated a more aggressive path to tightening, and as rates close in on the neutral rate, the market has priced in more of those moves. Therefore, we think it is an appropriate time to lengthen duration while, on balance, being short duration relative to the benchmark. In addition, given the significant flattening that has occurred in the yield curve, we believe investors may favor a more balanced underweight across the yield curve.

Selective positioning in corporate markets

Valuations remain well below long-term averages for high yield and bank loans, and are at fair value for investment grade corporates. In particular, we believe investors should be selective investing in both the investment grade and bank loan markets, where we have witnessed most of the excesses of this credit cycle. The investment grade corporate market has seen significant growth, along with a significant increase in leverage; 23% of the market trades over 4X leverage, compared to 13X five years ago. Duration has also extended in that market as issuers capitalized on low long-term rates and strong demand from liability-driven investors for long-duration corporates. The bank loan market has almost doubled in size since the financial crisis

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to almost $1.3 trillion, reflecting strong Collateralized Loan Obligation (CLO) demand. As a result, lower quality and smaller issuers have entered the market, covenant protection has declined significantly and leverage has increased.

Within investment grade corporates, we prefer the more highly regulated financial sector. Regulations limit event risk for the sector, including mergers and acquisitions, and share buybacks or higher dividends. We also favor the energy sector, particularly mid-stream companies that are benefiting from strong US GDP growth, higher oil prices and higher demand for pipelines to transport production from US shale oil fields. Within bank loans, we favor higher quality issuers with a greater asset base; in the absence of covenant protection, we believe investors need to rely on the underlying strength of the company's business model and balance sheet. Even in the high yield markets, CCC-rated valuations are the most extended; we believe investors should seek out the quality of BB- and B-rated companies.

AMUNDI INVESTMENT INSIGHTS UNIT

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