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INVESTMENT TALKS

15 December 2017

Investment takeaways from ECB year-end meeting

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KEY INSIGHTS:

- ***ECB growth expectations****: The Eurozone is ending 2017 on surprisingly strong footing, resulting in a significant upward revision for GDP growth in 2018 (from 1.8 to 2.3%).*
- ***ECB policy****: With inflation expectations mainly unchanged, the ECB is maintaining its accommodative stance for monetary policy and we do not expect this to change to June next year, when it is possible that after six further months of still strong growth, the bank's position (and perhaps the forward guidance) could shift to being less dovish.*
- ***Market impact****: We expect the reduction in the net asset purchases to exert upward pressure on the long-term term premium from January.*
- ***Euro****: After a period of relative stability for the EUR/USD, in the coming months, we expect the EUR to appreciate vs the USD, but with limited upside potential. In 2H18, we could see appreciation of the EUR vs the USD towards 1.22.*
- ***Fixed income investing****: We offer four adjectives to describe the right investment approach that fixed income investors should consider for 2018: flexible, dynamic, tactical and active. Bonds with low absolute yields represent an area where investors should be cautious, while high beta credit and govies trading at a spread could be areas of opportunities.*
- ***Multi-asset investing****: The increase in the cost of currency hedging for Euro-based investors favors the search for income from European equities. Multi-asset investors can also benefit from opportunities arising in currency dynamics and yield curve movements.*
- ***Risks****: It seems unlikely to us that financial markets will move smoothly in reaction to speculation about future moves in CB policy; we think it reasonable to expect greater volatility, especially after years of subdued volatility levels. Hence, we believe investors should maintain a cautious stance in terms of interest rates, increase liquidity, and focus on bottom-up credit selection. Higher short-term real rates are the key variable to watch in order to make a convincing call for rotation out of credit, and we are not yet there.*

What are the main messages coming from the year-end ECB meeting?

AB: The ECB made no change to the battery of tools it has been employing (rates, APP, reinvestments and forward guidance as decided in October). However, Mr Draghi issued the message that the Eurozone is ending 2017 in a surprisingly strong position, as the expansion gained in strength and breadth. This has occurred due to a number of growth engines working together: rising confidence, improved corporate profitability, and easy financial conditions are supporting investment, the improvement in the labour market is helping consumer demand, exports are supported by strong global demand. Despite this, inflation is still low (with underlying inflation even declining slightly recently) mainly because of the slow transmission of the improvement in the labour market to wages. Draghi mentioned repeatedly that the ECB, thanks to the growth momentum, is more confident that the target for inflation will eventually be reached. In any case, maintaining the envisaged highly accommodative stance for monetary policy is still needed (even though Draghi was more reluctant to say anything about what could happen after QE ends).

How would you expect the ECB's monetary policy to evolve in 2018?

AB: The ECB also presented its Economic Staff projection up to 2020: growth was revised strongly up (half a percentage point up for 2018, from 1.8% to 2.3%). Inflation was only marginally revised upward for 2018 (to 1.4% instead of 1.2%), unchanged for this year and 2019 (at 1.5%) and at 1.7% in 2020. While the wording has been that the ECB is more confident that inflation could trend close to but below 2%, projections do not entirely reflect that thinking. We believe that the growth picture is credible and our forecasts are close to those of the ECB. On inflation, however, we doubt anything spectacular will happen, though it is possible that numbers will be a tad higher (our forecasts are some decimals higher, particularly for 2019 and 2020). Hence, while we think that there will not be any change in the policy stance (with QE ending in September 2018), it is possible that in June next year, after six further months of continued strong growth, wording, and possibly the forward guidance, will shift towards a less dovish tone.

Would you expect any impact on the bond market from the reduction in the size of purchases under the asset purchase programme (APP) starting in January?

"We expect the reduction in net asset purchases to exert upward pressure on the long-term term premium from January".

BD: We expect the reduction in net asset purchases to exert upward pressure on the long-term term premium from January. In particular, the Eurosystem's holdings of German bonds taken in 10 year-equivalent terms should stabilise or even decline slightly in 2018. Recently, some technical factors have had a temporary negative effect on the "short euro duration". The first factor is the "end-of-quarter effect". This phenomenon can be explained by the "window dressing" of some banks wishing to report "better" balance sheets at end-of-quarter. Over the past quarters, both repo rates and the volume of repo transactions have declined before the end of a quarter as there was lower supply (higher search) of collateral. The second factor is the ECB front-loading its Public Sector Purchase Programme (PSPP) purchases. Even if the ECB were to halve the pace of its asset purchases in 2018, the volume of its PSPP purchases last week was the highest since March (€16.2bn). Note that the Eurosystem will pause APP purchases from 21st December to 29th December (purchases will resume on 2 January). This slowing had not been so strong last year and an acceleration of purchases in current market conditions has a strong impact. However, these two factors are temporary, as the end-of-quarter effect will be reversed in January and as the weekly PSPP pace will clearly be lower from early 2018. On top of this, net issuance of euro govies is usually strong in January and February.

What is your outlook for the Euro?

"After a period of relative stability for the EUR/USD, we expect the Euro to appreciate vs the USD in the coming months".

BD: After a period of relative stability for the EUR/USD, we expect the Euro to appreciate vs the USD in the coming months. The continuation of a solid recovery in the Eurozone paired with diminishing monetary accommodation from the ECB provides a positive backdrop for the single currency into 2018. The reduction we expect for the 10Y rate differential between the US and Germany should reduce the attractiveness of the USD vs the EUR on a carry basis. The upside potential for the EUR/USD rate should, however, be limited by both the dovish quantitative easing recalibration by the ECB for 2018 and the prospect of a tax cut in the US. On the positioning side, we believe this year's real money investors' shift from the USD into the EUR could remain in place, as an overall accommodative monetary policy stance should keep investors' risk appetites upbeat and favour the continuation of flows into European equities, thus offering the EUR an additional tailwind. In 2H18, we could see the EUR appreciate vs the USD towards 1.22.

From an investor perspective, in which areas of the market do you see the major opportunties and risks in this phase of "normalisation" of central bank policy?

"Four adjectives to describe the right investment approach that fixed income investors should consider for 2018: flexible, dynamic, tactical and active".

EB: Four adjectives to describe the right investment approach for 2018: flexible, dynamic, tactical and active. Why? The road to a less controlled market will not be long and easy. The risk is about markets possibly being trapped between what is the current state of the market (a predominant buyer not concerned about yield and return) and what could be the future of the market (where private investors will evaluate risk/return before buying, as per the "old days" of fixed income markets). This transition will not be linear and thus will require agility with regard to how portfolios are managed. A prolonged period of low rates/tight spreads is not to be feared, as it is still an environment in which we believe active managers can deliver alpha[1]. Neither should we fear a step-up adjustment, or an increase in volatility, which would be welcomed

[1] Alpha: the additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager vs the index

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indeed in order to ease valuations. Moving forward, a flexible active management approach should provide the means to navigate in more difficult conditions.

From a global bond perspective, in which areas of the market do you see the major opportunties and risks in this phase of "normalisation" of central bank policy?

"Low absolute yield bonds are areas where investors should be cautious, while high beta credit and peripheral government bonds could be areas of opportunities".

EB: Normalisation of central bank policy means higher rates: high duration and low absolute yield are thus areas regarding which investors should be cautious. Risk/reward seems very low in these market segments. For example, 10Y German government bonds give investors 0.30% yield[2] for one year which would be offset only by marginal increase in rates. The same is true for credit with very low spreads. However, as "normalisation" should not translate into an aggressive stance at this stage for central banks, there are still opportunities in assets with decent yields: high beta credit, govies trading at spread will harbour areas of opportunity that could outpace their risks. Inflation-linked bonds should also be considered: if there is normalisation, it will be a reflection of CB inflation targets being within sight, ie, closer to our forecast. As valuations of break-even are still very low, this market area could provide protection at a low cost when and if the market reacts more nervously to central bank movements.

From a multi-asset perspective, do you see any opportunity from the current phase of asynchrony in central bank policies?

"From a multi-asset perspective, the current phase of asynchrony between central banks' stances increases the cost of currency hedging for Euro-based investors".

FS: From a multi-asset perspective, we think that the current phase of asynchrony between central banks' stances can hide pitfalls as well as opportunities.

When we analyse specifically the stances of the ECB and the Fed, we acknowledge the different speeds in policy normalisation. This will likely point to a wide LIBOR rates differential making the hedging for a European investor extremely high on an historical basis. The presence of such wide hedging costs makes it less appealing for European income investors to use higher carry asset classes such as HY and EM in hard currency (USD) and is more favourable for a search for income from equity (ie, European equities). Among the opportunities we see coming from this global asynchrony, we can list some in the FX space or in yield curve movements: regarding the former, we have a positive view on the NOK vs the EUR; on the latter, the steepening of inflation-linked bonds in the US, or the flattening of 2-10Y on the Swedish curve due to the stance of the Riksbank, which could consider raising the benchmark rate of -0.5% given a more benign inflation outlook. In the UK, we think that the Bank of England will experience strong headwinds if raising rates amid rising inflation concerns. Hence, we continue to believe that UK real rates will trend lower.

In your view, are financial markets too complacent on a potential correction in bond yields and how should multi-asset investors act in this respect?

"Markets currently appear very complacent about liquidity and credit risks, but inflation dynamics in 2017 have not been showing signs of overheating. Higher short-term real rates are the key variable to watch to call for a convinced rotation out of credit, and we are still not there".

FS: We understand the desire of Central Banks to move in a rather synchronised way in order to avoid disordered exits from a large range of crowded income trades, primarily on the high grade fixed income range. We believe that such aspirations are coherent and linked to plans to maintain a low volatility regime and rather subdued levels of credit and liquidity risks. It's difficult to believe financial markets will move smoothly in reacting to speculation about future moves; it's reasonable to expect fatter risk tails, especially after years of subdued volatility. Hence, we believe investors should maintain a cautious stance in terms of interest rates and spread duration. It will also be crucial to increase the liquidity in invested portfolios as well as a focus on bottom-up credit selection to avoid credit events. Specifically, this would mean avoiding companies with spreads per units of leverage appear extremely low. Markets currently seem very complacent about liquidity and credit risk, but it seems fair to admit that inflation dynamics in 2017 have been rather far from overheating. Higher short-term real rates are the key variable to watch in order to call for a convinced rotation out of credit, and we are still not there.

[2] Source: Bloomberg, data as at 15 December 2017.

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Important Information

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

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