

Bank balance sheets: for high quality, the tide has turned

In our February commentary, “Of bank balance sheets, private and public,” we discussed the forthcoming shrinkage in the Federal Reserve’s balance sheet and wondered whether constraints on private sector balance sheets might be loosened in the near future as well.

On June 12, the U.S. Treasury made recommendations for doing just that. This trend is important for several reasons. First, the pendulum of financial regulation has clearly reached an apex and begun to swing toward easier rules. Second, the change in direction will liberate bank capital for deployment in

capital markets and real economic activities. There are implications for the credit cycle and for relative pricing of high credit quality securities, which is the “bread and butter” of many investment strategies we manage. Third, the proposed changes will facilitate the transfer of Treasury and government MBS from the Federal Reserve’s balance sheet to private hands, thereby mitigating the impact on capital markets.

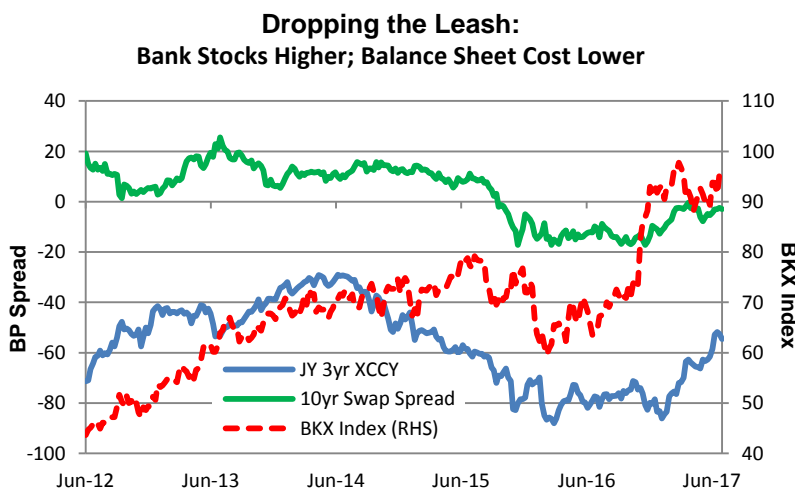
The wholesale banking system was Ground Zero in the Global Financial Crisis of 2007 to 2009. Money market

funds and short-term repurchase agreements were used as instruments of “maturity transformation.” While these instruments were low-risk in isolation and in normal times, during the GFC they became the Achilles’ heel of the world financial order.

Understandably, bank and securities regulators introduced substantial reforms in these areas. They pushed \$1 trillion from prime money funds into government-only funds and constricted bank repurchase activity by imposing high minimum capital requirements on all bank assets, even if the assets were Treasuries held as repo collateral. Total dealer repurchase balances contracted by over \$3 trillion since 2007 and almost \$1 trillion since the higher capital requirement was announced in 2013.

To protect the system wholesale from banking panics, reform and regulation dramatically raised banks’ cost of low-risk, balance-sheet intensive activities. Cash instruments cheapened to derivatives across markets, most notably in Treasuries versus interest rate swaps. Ten-year swap yields dropped to as much as 17 basis points lower than (better-credit) Treasuries, and 30-year swap spreads almost reached minus 60 basis points! For international readers of this commentary, you know that banks charged a balance sheet fee for hedging investment into U.S. dollars, as reflected in cross-currency basis swaps. At the three-month tenor, during 2016 the “rental” fee reached 80 basis points for Japanese Yen and 60 basis points for Euro hedges, above and beyond the normal money-market differential.

The Treasury’s June 12 proposals are currently just recommendations, although most can be implemented by regulators without new legislation. Market consensus appears to be that changes to the key leverage



Source: Bloomberg. As of July 7, 2017. XCCY = cross-currency basis

Source : Amundi. Past performance is not a reliable indicator of future results or a guarantee of future returns.

(SLR) and liquidity (LCR) rules will take one to two years to implement. But market prices for longer-dated securities and contracts have already anticipated an easier environment.

The rule changes will affect wide swaths of U.S. fixed income markets, and have begun to do so already. Here is a partial list of likely market moves in the event of substantial implementation of the Treasury's proposals:

1. Intermediate- and long-term swap spreads will widen, with longer-term spreads widening the most. *I.e.*, Treasuries will richen, and the Treasury curve will flatten relative to swaps.
2. Dealers will increase Treasury repo balances, leading to a reduction in repo provision by the Federal Reserve.
3. Repo bid/offer spreads will narrow.
4. Cross-currency basis swap spreads will move closer to zero, increasing international interest in owning U.S. Treasuries relative to foreign bonds. *I.e.*, This will support lower relative U.S. yields.
5. Federal Reserve tapering will have less of an effect on Treasury yields than in the absence of the rule changes.
6. GNMA's will cheapen relative to FNMA and FHLMC MBS, related to easing of liquidity rules.
7. Corporate bonds and FNMA and FHLMC MBS *may* follow swap spreads in widening to Treasury yields.

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convictions

Key allocation themes across our strategies

Once again, too much scepticism about inflation expectations!

Investors' scepticism about inflation expectations in the eurozone still abounds. Unusually large issuances, erratic movements in oil which has crossed the \$50/barrel threshold, and a stronger-than-expected decline in the consumer price index (+1.3%) after an expectation-beating peak of 2% in February are to blame. Dismissing the reflation scenario, investors have taken only a tiny step since last March.

And because in this market, all movement seems to snowball, the ability to absorb a rise in this asset's rates has been completely ignored. However, statistic after statistic shows that the economy is improving, with the unemployment rate even implying that we may be getting close to the European economy's natural rate; these are just some of the ingredients that should push up the values of inflation-linked bonds.

The level achieved by inflation expectations calculated by swaps reveals investors' scepticism: it is based on the level of core inflation (1.2% in April, 0.9% in May, 1.1% in June) without factoring in its future trend. So where has the expectation aspect gone? This is happening even as the ECB is regularly publishing a set of alternative measurements that give better insight into the intrinsic direction of prices. Whether by weighting the various components inverse to their volatility, or by eliminating the 10% or even 30% of components with the highest variation, everything points to slightly more firmness in the core range of prices.



Source : Bloomberg

It looks even worse when you examine inflation expectations taken from German bonds, for example, which emphasise the impact of the issuance policy. Longer and larger issuances, i.e. nearly €80m annualised in 10-year equivalents, compared to an annual amount that did not exceed €70m in recent years.

In short, this asset is deeply discounted once again. It may benefit from improved visibility into the price increase trend, with relative stability in the upcoming figures, bringing its value more in line with the current economy. This is why we have retained a large exposure to a rise in inflation expectations, particularly in the eurozone.

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Key allocation themes across our strategies

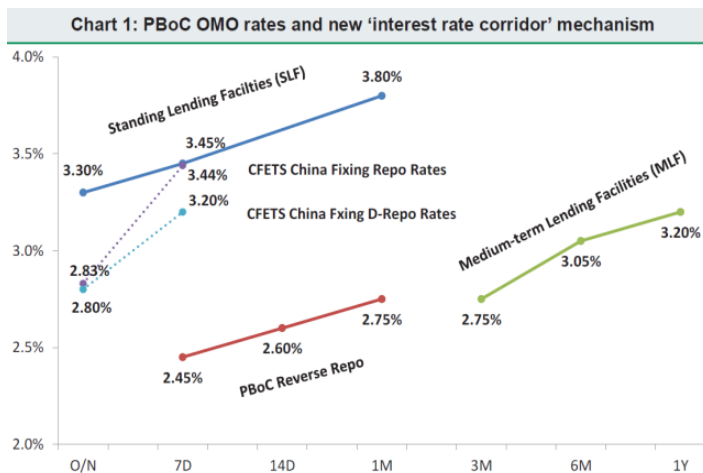
What aspects of the Chinese interest rate markets are important to track?

As the emphasis of Chinese monetary policy moves from targeting the rate of money supply (quantity) growth to interest rates (price), it is increasingly important to understand the key interest rates to better gauge the pulse and policy intent of Chinese monetary policy. This helps us to decipher the drivers in the rate markets such as deleveraging, money market liquidity and shadow banking, which in turns helps to extrapolate the macro impacts of interest rate trends and possibly help in implementing investment ideas.

Broadly, there are four tiers of interest rates in China. Base money is transmitted into the economy (i) from the central bank (PBoC) to the large banks, (ii) from the large banks to other financial institutions, (iii) from financial institutions to corporates and retails, and (iv) from off-balance sheets (shadow banking) to restricted corporate sectors and private financing or the credit starved SME sectors.

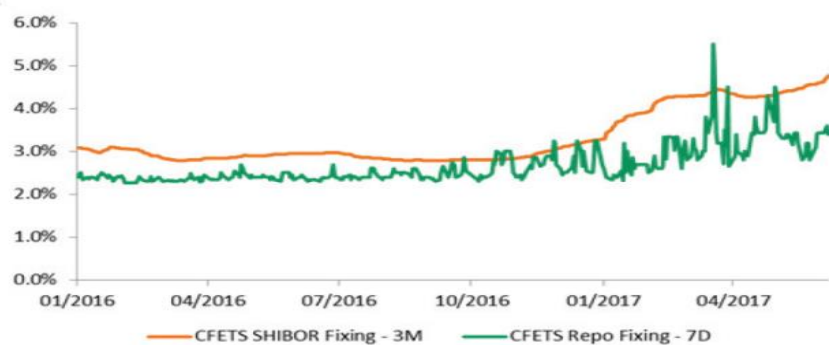
I PBoC open market operations. The base money supply initially flows from the PBoC to the large FIs via open market operations. The PBoC has been trying to create a proxy ‘interest rate corridor’ mechanism. The PBoC’s reverse repo operations (reverse repo rates are now the new short-term benchmark rate) and medium-term lending facilities (likely the ceiling of the interest rate corridor) are now the most important monetary policy instruments, and have replaced the traditional banks’ RRR to adjust the base money in the banking system.

II Interbank: repo, SHIBOR and interbank borrowing rates. Repo fixing rates are benchmark rates based on the repo trading rate for the interbank market and gives an indication of the extent of deleveraging induced by the PBoC via the large FIs. The first stage of deleveraging began in October 2016 where the seven-day repo fixing rate become more volatile and expensive. One of the most popular ways to add leverage in the bond market is via pledged repos, especially in the overnight tenor. We are currently seeing the second stage of deleveraging, where we note that the 3M SHIBOR rise is continuously causing the off-balance sheet activities in commercial banks to unwind.



Source : Bloomberg

Chart 2: 7-day repo fixing and 3-month SHIBOR fixing



Source : Bloomberg

III Corporate borrowing rates: benchmark lending rate, corporate bond yields and WMP yields. Many Chinese corporates have diversified their funding channels from bank loans to the bond market. However, credit bond yields have been increasing (AAA corporate yields from 4% to 5.5%) since September last year, in line with the PBoC’s tighter monetary policy. Given that banks have limited loan quotas and have to control their NPLs, some private firms such as those over-capacity industrials and smaller property developers need to turn to shadow

banking channels instead. This is often done via issuing wealth management products (WMP). Watching how the corporate borrowing costs incurred via corporate bond yields and WMP yields compare to the benchmark lending rates will be key to understanding how much funding stress corporates face.

IV Shadow banking interest rates and peer to peer (P2P) rates. Further down the tiers for even smaller SMEs will be trust loans in the shadow banking business and peer to peer internet financing. These financing tools are often very short maturity (in the range of 6 months to 2 years) with rates in the range of 6% to 12%.

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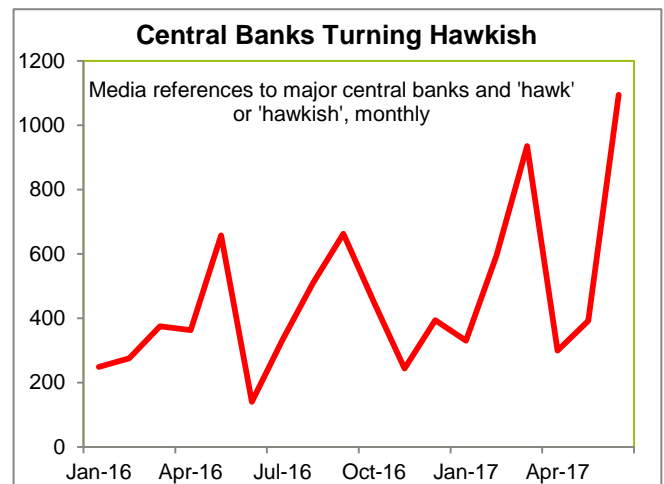
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Key allocation themes across our strategies

Why have central bankers suddenly turned hawkish?

The last few weeks have seen a sea-change in central bank communications. Earlier in the year, all the major central banks had been preaching a sermon of gradualism and data dependence. To the extent they intended to normalise policy, it would happen only slowly and would be copiously telegraphed. This has changed: the June FOMC meeting hiked rates, and, more surprisingly, made only minimal changes to its economic projection ‘dot plot’. A few days later, The Bank of Canada also appeared to signal a change of heart as it said it sees encouraging signs of broadening growth. The Bank of England’s policy committee saw a close vote as it kept rates on hold, but with three MPC members voting for a hike, and with both the Governor and Chief Economist subsequently suggesting the case for a hike has strengthened. Then, at the central banks’ forum in Sintra, Portugal, ECB President Draghi talked of better growth prospects for the eurozone.

Combined, these apparent changes of view sparked a sell-off of core fixed income bonds and put pressure on some risk asset spreads. The surprising combination of these more optimistic comments led conspiracy theorists to suggest there had been some unwritten ‘pact’ among central bankers to trigger a sell-off to ward off threats to financial stability from asset price ‘bubbles’. This is unlikely. Central banks are still very aware of the danger of a ‘taper tantrum’ similar to that triggered by Ben Bernanke in 2013. They are therefore extremely sensitive to the need to communicate with markets. Moreover, coordination



Source : Bloomberg

between central banks does not happen in the ‘cloak-and-dagger’ manner that conspiracy theorists love to imagine, but rather through an ongoing dialogue of ideas, analyses and commentary in which they operate.

What is common to all the central banks recent comments is a growing feeling that the global economy is no longer in a state of crisis that alone justifies an emergency setting for monetary policies. Some countries are more advanced than others, but all have made substantial progress in recovering from the global financial crisis, and addressing many of the vulnerabilities in their financial systems. The eurozone’s progress in recent months has been impressive. Central bankers therefore feel increasingly awkward as they look at the array of emergency and unconventional tools they are using, and yearn to get back to a much more traditional toolkit consisting of positive policy rates, modest-sized high-quality balance sheets, and open market operations to control bank liquidity. Several heads of major central banks will come to the end of their terms in the next few years, and they are thinking about their legacies: they know their successors will not thank them for bequeathing a complex web of standard and non-standard measures. So, to the extent there was any agreement among central bankers that prompted the change of tone, it was a ‘dog-whistle’ message that things are looking a fair bit better, and that we should all therefore start thinking about steps to normalise policies.

There has been one standout point of resistance to this trend, and for very good reasons. The Bank of Japan has been sticking, in a very disciplined way, to its Yield Curve Control and Quantitative Easing hymn-sheet. The recent sudden strength of the yen—now thankfully abating—was threatening to push back attainment of the 2% inflation goal and undo much hard-won progress. Governor Kuroda has therefore dismissed all requests to speculate about an ‘exit’ and has stuck to his agreed script. Little by little, the very easy monetary policies appear to be helping the Japanese economy recover.

Even following the recent sell-off, we see little value in core government bonds. A synchronised global growth upturn is underway and output gaps are shrinking. In some economies, fiscal policy is still hard to predict and geopolitical concerns remain a tail risk for investors, but bond term premia remain negative and mean risk can be deployed much better on other parts of the portfolio.

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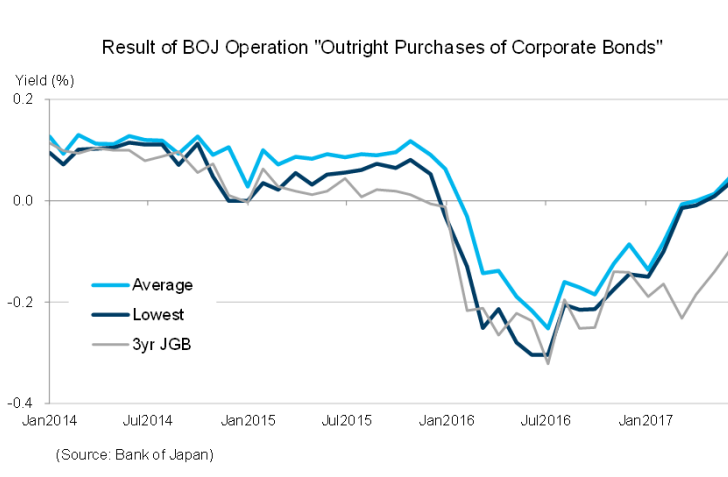
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Key allocation themes across our strategies

Limited space to play on the JGB market

The global economy is gradually recovering or growing. In the US, the Fed has already raised rates four times since December 2015, bringing the Federal Funds Rate to around 1.25%, and is considering compressing its balance sheet by terminating reinvestment of its Agency MBS portfolio. In Europe, the ECB is also considering tapering the amount of its bond purchasing programme in order to begin normalising its monetary policy. Particularly, the result of French presidential election seems to have made market participants feel more confident about the stability of the market, though there are still concerns about the financial system in some peripheral European countries. Supported by the positive economic outlook and the expectation of QE tapering, European government bond yields are increasing, following US yields.

Japan seems to be exceptional. Actually, we have confirmed that business sentiment is recovering and the labour market is correlating closely with the global market trend, however, we cannot find any signal that points to inflation rising towards 2%, or even 1% in the near future. With such a low expectation of inflation, the BOJ is not allowing the JGB yield curve to rise along with the other developed markets. On 7 July, the BOJ announced its JGB purchase operation, in which it would acquire 10-year JGBs at 0.11% with no limit on the amount. Market participants immediately understood the BOJ's intention and the 10-year yield moved to 0.094% from 0.104%. The BOJ's YCC policy is still working powerfully to contain the 10-year JGB yield within a range of 0% and 0.10%.



While the 10-year yield is strictly suppressed to not rise beyond 0.10%, the shorter end of the curve is continuously rising to get back to positive territory. As you can see in the chart below, the BOJ is increasing the yield level of the short-term corporate bond which it purchases through its programme. With the 10-year yield stable at around 0.10%, the increase in the shorter end of the curve makes the curve flatter, in order to keep the curve flat beyond the 10-year maturity. There is limited space, on the 2-5 year slope, to play on the JGB market. The shape of the 2-5 year slope has been changing more than the 5-10 year slope, reflecting the change in expectations for inflation or economic growth.

Currently, we are neutral on the 2-5 year slope, waiting for the opportunity to build a flattening position while taking profit on the 5-10 year flattening position.

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