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Amundi ASSET MANAGEMENT

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DIVERSIFY RISK IN FIXED INCOME AS FED UNWINDS ITS BALANCE SHEET

INVESTMENT TALKS

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What are the major take aways from the Federal Open Market Committee?

Drut: Even if it was broadly expected, the decision to start the reduction of the balance sheet is historical. It comes after three rounds of asset purchases and as the Fed is the first major Central Bank to engage in this policy. The projections for the Fed Funds (the so-called 'dots') are rather aggressive as they show that FOMC members plan to hike the Fed Funds in December and three times next year. However, they lowered their estimate of the terminal[1] Fed Funds range slightly below 3%. While the FOMC statement acknowledges the negative impact of the hurricanes Harvey, Irma and Maria on activity, it continues to expect that economic activity will expand at a moderate pace. FOMC members have even raised their GDP growth forecasts (from 2.2% to 2.4% for 2017). During her press conference, Janet Yellen declared that the unexpected slowdown of inflation this year had 'something of a mystery', which highlights that the low inflation figures will remain a challenge for the Fed.

What are the risks of a US recession or deep deceleration of the US economy?

Drut: We do not see signs of an imminent recession in the United States. We anticipate GDP growth of 2% in both 2017 and 2018. We are probably reaching the late stage of the business cycle. This cycle is already one of the longest in American history. The US economy is now nearing full employment without generating the inflationary pressure usually recorded at this stage of the cycle. The main weakness of the US economy lies in the corporate sector, due to the consequences of years of easing monetary policy. Non-financial corporate leverage increased during the period 2013-2016 to stabilize on record high levels over the last quarters. The exceptional financing conditions in the credit markets have motivated companies to increase their leverage. The IMF has warned that the number of firms with very low interest coverage ratio is already high. Furthermore, some FOMC members also considered in their discussions of financial stability: the low level of volatility, equity valuation and the pace of increase in real estate prices in the multifamily segment.

What is your expectation for the Fed monetary policy going forward?

Drut: We expect the Fed to implement the plan of balance sheet reduction it has announced. According to our calculations, the Fed will non-reinvest $18 bln of US Treasuries in 2017, $229 bln in 2018 and 263 $bln in 2019. Doing so, the Fed's balance sheet size should account for $4 trn at the end of 2018 and $3.5 trn at the end of 2019. The net issuance of LT US Treasuries that non-Fed investors will have to absorb will converge to almost $1 trn in 2019 (back to 2012 levels). In addition, we also expect the Fed to hike the Fed Funds in December and also twice in 2018, i.e. more than is currently priced in by financial markets.

The FOMC projections reduced their estimate of the terminal rate to 2.75%. The lower terminal Fed Funds rate means that the Fed is modestly closer to the end of its tightening cycle.

With the FOMC's changes to its projections for the terminal Fed Funds rate, what are the implications for the path of interest rates going forward?

Melchreit: In keeping with Chairwoman Yellen's recent observations regarding a potential decline in the terminal Fed Funds rate, the FOMC projections indeed reduced their estimate of the terminal rate to 2.75%. This lower rate reflects, among other things, a view that both GDP growth and inflation may be lower than historical levels, reflecting the impact of aging demographics in the U.S., lower productivity (cited by Fed Chair Janet Yellen in her press conference today) and a more globally integrated economy. This lower terminal Fed Funds rate means that the Fed is modestly closer to the end of its tightening cycle; the Fed also extended the period for rate hikes, reducing 2019 hikes from three hikes to two. This lower terminal

[1] Terminal rate is the natural or neutral interest rate, consistent with full employment and capacity utilization and stable prices.

(so-called "normalized") Fed Funds rate also has implications for the 10-year Treasury, which may now have a normalized range of approximately 3.5% to 3.75%.

What are the implication of the debt ceiling[2] issues on US Fixed Income?

We believe the likelihood for a successful and timely resolution of the debt ceiling issue has risen.

Melchreit: The extension of the U.S. debt ceiling to December 15 was approved by Congress in early September, pushing off the day of reckoning; most likely, the U.S. Treasury will soon announce the extension of "extraordinary measures" beyond the current September 29 extension to conserve cash, so that the government will have funding until early into the second quarter of 2018. While debt ceiling negotiations may introduce short-term volatility into the U.S. Treasury market, we view the potential for an actual default as quite remote. All told, it is no one's interest to trigger a default on U.S. debt. Trump's recent willingness to work across the aisle in extending the debt ceiling surprised Washington, and should increase the probability of a timely debt ceiling resolution. Moreover, President Trump has suggested that the concept of a debt ceiling be eliminated, thereby doing away with the recurring volatility and brinksmanship that seems to accompany extension negotiations. Whether deficit hawks will approve this approach is debatable. Regardless, although the debt ceiling remains a near-term issue, it has now been separated from the December budget and tax reform/cut negotiations, and we believe the likelihood for a successful and timely resolution has risen.

Which forces do you see prevailing on US treasury markets in the next six months?

We continue to favor credit sectors based on solid fundamentals, and we are very cautious on the most rate-sensitive sector of government securities.

Melchreit: Over the next six months, the U.S. Treasury market may be most affected by the Fed's communications regarding rate increases in December and in 2018, which have been more hawkish than what was priced in to the market. In addition, the outlook for inflation will have a major impact on Treasury markets, particularly on long-term Treasuries, that have seen the inflation rate implied by TIPS fall from near-term February highs. Both inflation and GDP reports, however, may reflect the short-term impact of the rebuilding from Hurricanes Harvey and Irma, so that data may be "noisy" over the next few months. High frequency online price series, which were a good prediction of the softness of CPI earlier in the year, have recently strengthened quite considerably. Finally, we believe monetary policy of global Central Banks may have an important impact on U.S. Treasury rates. Should the ECB decide to reduce asset purchases in October, we believe that decision may result in higher global yields, as a further indicator of the convergence of global monetary policy to a tightening bias.

What is your short and medium-term outlook on the USD?

Melchreit: While the Fed's more hawkish than expected stance on monetary policy may bolster the Dollar in the very near-term, we believe that converging global monetary policies, as well as a stronger global growth outlook, will put further pressure on the Dollar over the next few years. The dollar may depreciate in the intermediate-term, as yield differentials between the U.S. and developed markets narrow. Strong global growth, including in China and Europe, may drive more developed-market central banks, including the ECB, to begin reducing quantitative easing. In addition, Trump's preference for a lower Dollar, combined with the four openings on the FOMC, and the potential for more expensive trade, may put a brake on dollar appreciation.

How should US fixed income investors deal with the new market phase ahead?

Investors should diversify their risk exposures, including MBS risk in additional to corporate credit risk, and seek out other exposures as opportunities present themselves.

Melchreit: We believe we are facing a rising interest rate environment in a period of solid economic growth, both in the U.S. and globally. At the same time, spreads in a broad range of credit sectors stand well below long-term averages. In this environment, we continue to favor credit sectors based on solid fundamentals, and we are very cautious on the most rate-sensitive sector of government securities. Investors may wish, however, to reduce overall credit risk in light of more challenged valuations. In addition, investors may be well-advised to diversify their risk exposures, including taking Mortgage Backed Securities (MBS) risk in additional to corporate credit risk, and to seek out other exposures as opportunities present themselves. We believe investors should actively manage duration and yield curve exposure. In the current

[2] Debt ceiling: a cap on how much money the government can borrow to pays its bills and repay off its loans.

rising rate environment, it may make sense to hold a relatively shorter duration position relative to a broad fixed income benchmark, to help mitigate the negative impact of rising interest rates.