

Cautious on yields, selective on spreads amidst a more confident FED



Bastien DRUT
Fixed Income and Forex Strategist



Charles MELCHREIT
Deputy Head of Fixed Income, US



Annalisa USARDI
Senior Economist

With the contribution of :
Meredith Birdsall, Client Portfolio Manager, US Fixed Income
Paresh Upadhyaya, Director of Currency Strategy for US Amundi Pioneer

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- **Fed:** The FOMC left the funds rate target range unchanged at the January meeting (1.25%-1.50%), reinforcing, in our opinion, the likelihood of delivering three hikes this year.
- **Economy:** The economic assessment, upgraded in some part, highlighted that all domestic engines of growth (employment, household spending, business fixed investment) are working properly to propel strong demand. The Fed also upgraded the inflation assessment, recognising improvements in some compensation measures.
- **US dollar:** Different factors point to a continuation of dollar weakness and we forecast a modest trade-weighted depreciation for the USD this year. This being said, the current pace of USD depreciation seems exaggerated and this could lead to some corrections.
- **Market:** We believe investors should position their portfolios to defend against rising interest rates, with underweight positions in U.S. and hold overweight vs. the index in a diverse range of spread sectors. We would recommend an overweight to securitized sectors. Given extended valuations across both U.S. investment grade and high yield markets, we do not believe this is a time to be overly exposed to credit risk, particularly corporate credit risk.

What are the key messages coming from the January FOMC post-meeting statement? Any material difference with December meeting?

A.U. The FOMC held the federal funds rate unchanged in the 1.25% to 1.50% target range reinforcing, in our opinion, the likelihood of delivering three hikes this year.

In fact, the economic activity was described as expanding at a solid rate, and ‘solid’ was also the word used to describe gains in employment, household spending, and business fixed investment. This economic assessment, upgraded in some part, highlighted that all domestic engines of growth are working properly to propel strong demand. On the employment and economic front of its dual mandate, it’s a “mission accomplished” for the Fed.

Yet, core inflation is missing the target, running below 2%: the FOMC recognized that “market-based measures of inflation compensation have increased in recent months” which is also an upgrade compared to past assessments (previously they were “remaining low”); this recognizes that these measures have bottomed out, although remaining still below historical standards, and we could take this as a positive sign that the Fed thinks inflation is moving in the right direction. All in all, the assessment of risks remain roughly balanced and the Fed now sees “further” gradual increases as appropriate. The forward guidance gives in our opinion the leeway for implementing fully the dots this year, but more color on the reasons why this “further” was included will be found perhaps in the minutes of this meeting, published in a few weeks.

What are the key challenges that the new Fed Chair Powell will have to address from February?

A.U. Governor Powell will be sworn in as Chair on February 5th and his first big event will be the semi-annual monetary policy report to Congress mid-February. Chair Yellen set the Fed on a path of “normalization” that we expect Chair Powell to follow without major disruptions, continuing a gradual tightening cycle. The major challenge for the Fed will be to balance the gradual tightening in a way to allow domestic forces to lift core inflation to the target while maintaining inflation expectations anchored without any abrupt tightening in financial conditions.

In this framework, there is a recent ongoing debate, fostered by current and past Fed members, on how monetary policy forward guidance and mandate could potentially be modified in order to make it more effective, in particular in a low-rates environment and after

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“We forecast a modest trade-weighted depreciation for the USD this year, with the possibility of corrections given the rapid recent movement”.

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“We believe that conditions are in place for further potential increases in market inflation expectations”.

a period of inflation target undershooting. We expect this to be a key theme attracting attention and being addressed under Chair Powell, although this debate eventually may well not end up in a change in the Fed monetary policy objectives or forward guidance.

Do you see the current US dollar weakness to continue? After the recent quarrels, do you see risks of political interference into the FX markets?

B.D. The depreciation of the US dollar is all the more disconcerting, as long rates have risen in the US more than in the other developed countries since October. But one should also remember that the dollar had depreciated continuously during the 2004-2006 Fed funds tightening cycle as global growth was strong, as the other developed economies were catching up with the US and as commodity prices were booming. Several other elements can partly explain the USD depreciation:

- The rise in oil prices. Even if the negative link between oil and the dollar is weaker than before, it is likely that part of the decline in the dollar comes from the rise in oil prices.
- The rise in the cost of the currency hedging of US assets for European and Japanese investors: US short-term rates are continuing to rise while European and Japanese short-term rates remain negative. This might discourage the purchase of US assets.
- The uncertainties about the US economic policy. In Davos, the Treasury Secretary Steven Mnuchin and the Trade Secretary Wilbur Ross adopted an offensive communication on the trade policies of other countries, fueling the theme of the trade war. Mnuchin further stated that a weak dollar was in the interest of the US economy. The next day, President Trump retracted his remarks and said he wanted to see the dollar stronger "ultimately" because that would be a sign of the strength of the US economy. Overall, these statements have clouded the US government's intentions on several topics including the dollar.

But even some of these themes are here to stay and that we forecast a modest trade-weighted depreciation for the USD this year, the current pace of USD depreciation seems exaggerated and this should lead to some corrections.

How technical factors are going to influence US fixed income market in the next few months?

C.M. The Fed has started to non-reinvest maturing assets in October. For the time being, the reduction of the balance sheet has been very limited in terms of quantity but the pace of the balance sheet reduction will increase quarter after quarter. The impact of this decision is relatively limited for the time being: according to the Fed staff's calculations, the 10-year term premium¹ is currently depressed by the Fed's balance sheet-related policies (QEs, Operation Twist) by 85 bps and it should increase by 14 bps in 2018 because of the Fed's non-reinvestments of maturing assets and because of the ageing of the Fed's portfolio. Globally, the contribution of balance sheet reduction will be small but will complement other factors like the continuation of the repricing of fed funds expectations. For the first time for years, long-term rates are following the same path of short-term rates and there is a kind of normalisation of the yield curve's behavior. The pause of the yield curve's flattening is noticeable and should last some time as long-term rates will continue to evolve in tandem with short-term rates.

Do you expect the repricing of inflation in the US Treasury to continue? How far can it go?

C.M. Inflation expectations as reflected in Treasury Inflation Protected Securities (TIPS) now stand at 2.11%, having risen from a near-term low of 1.66% in mid-2017. This represents the highest level since August, 2014. Yet we believe that conditions are in place for further potential increases in market inflation expectations. Indeed, broader inflation measures, including service inflation, continue to increase. Importantly, inflation pressures are building in

¹Term premium indicates the excess yield that investors require to commit to holding a long-term bond instead of a series of shorter-term bonds

several different parts of the economy. Wage inflation should continue to accelerate as labor markets further tighten in the strong growth environment. Employment Cost Index (ECI) has risen 2.6% year over year, versus 1.9% two years ago. More restrictive immigration policies, which represented the dominant theme in President Donald Trump's State of the Union speech, should exacerbate already tight labor markets. The potential for further declines in the US Dollar means that import prices will rise, further contributing to inflation. Finally, tax reform, which will increase corporate profits and income for some households, has the potential for being an additional inflation catalyst, and may have been a primary contributor to higher inflation expectations since December. The rising upside risk to inflation has the potential to lead to an overshoot of the 10-year TIPS breakeven, perhaps to 2.4% or even beyond.

What else will drive the US Yield curve?

C.M. We think the US yield curve will be driven by three primary factors. First, the curve will respond to the Fed's rate increases; the yield curve typically flattens when the Fed raises rates. Second, the yield curve responds to inflation expectations. The yield curve has steepened in the last month in response to higher inflation expectations, with 10-year Treasury yields increasing more than 2-year Treasury yields. Finally, the yield curve will respond to demand from non-US investors, which will be heavily influenced by the monetary policies of global central banks. Over the past year, the divergence between US and global monetary policy and the negative/ultra-low yield environment dominant within non-U.S. developed markets, has driven non-U.S. investors to seek out high-quality, high-yielding assets. Investors have been willing to go out along the curve in search of higher yield. Improving global growth should, at some point, drive greater tightening among major non-US central banks, which could result in relatively higher long-term yields in the U.S.

Do you see areas of overheating in the credit market? Here, what are the opportunities left?

C.M. Within the credit markets, we believe that investment grade corporate spreads, in particular, signal stretched valuations. While we see minimal risk in the economic cycle over the next eighteen months, valuations are extremely tight (bottom decile historically) and on this basis, we would suggest to reduce credit exposures and upgrade quality. Investment grade corporate spreads already stand at near all-time lows, adjusted for duration and quality, and we believe they already price in the benefits of corporate tax cuts.

What we think may have been overlooked, is the potential negative consequences associated with the repatriation of offshore cash. As corporations take advantage of the one-time 14.5% tax on repatriating offshore cash, they may also sell investments within those cash portfolios, including short-term investment grade corporates. Those sales may cause corporates spreads to widen. As corporations make decisions on how to deploy that additional cash -- whether it be an increase in share buybacks or dividends, or an increase M&A activity -- either of those choices could result in spread widening. Share buybacks/dividends would result in increased leverage ratios, and M&A activity could result in increased debt issuance, again increasing leverage.

We think it is appropriate for investors to reduce exposure to lower-rated high yield instruments. The tax law and set limits on interest rate deductibility at 30% of EBITDA have placed more pressure on highly leveraged high yield issuers. This will also limit new private equity activity, which at the margin may ultimately result in improved credit metrics within the bank loan and high yield markets, but that migration will occur over several years, not several months.

We see more attractive valuations within structured securities, within both agency and non-agency Residential Mortgage Backed Securities (RMBS). Fundamentals within the housing market remain positive, spurred by strong GDP growth and employment, and still reasonable mortgage rates. In addition, we believe that agency Mortgage-Backed Securities (MBS) offer investors reasonable value at current spreads. While certain investors are concerned about the increased net supply of approximately \$400 billion forecast for 2018, we believe that the market has already priced in this forecast (which we witnessed earlier in 2017 when the Fed

“Improving global growth and greater tightening among major non-US central banks could result in relatively higher long-term yields in the U.S as demand from non-US investors would decline.”

“Within the credit markets, we believe that investment grade corporate spreads in particular signal stretched valuations. Also lower-rated high yield instruments are not appealing”.

“We see more attractive valuations within structured securities for fundamental and technical reasons”.

first announced the taper plan). The Federal Open Market Committee (FOMC) has been fully transparent in setting forth its tapering program with respect to both U.S. Treasuries and agency MBS. Moreover, agency MBS already extended duration in the fourth quarter of 2016, in response to higher rates, and we do not foresee significant extension risk going forward. High quality non-agency RMBS remain attractive, with pristine credit metrics and almost 1% higher yields than agency MBS.

“While fundamentals remain strong, with stretched valuations, we are cautious on credit risk.”

How should investors play the current phase in US fixed income market?

C.M. We believe investors should position their portfolios to defend against rising interest rates, with underweight positions in U.S. Treasuries vs. the Bloomberg Barclays Aggregate Bond Index, and hold overweight vs. the index in a diverse range of spread sectors. We would recommend an overweight to securitized sectors, particularly both agency and non-agency RMBS. Given extended valuations across both U.S. investment grade and high yield markets, however, we do not believe this is a time to be overly exposed to credit risk, particularly corporate credit risk. We are adhering to our time-tested approach based on valuations and fundamentals. While fundamentals remain strong, with stretched valuations, we are cautious on credit risk.

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