Amundi
ASSET MANAGEMENT
AMUNDI Fixed Income
The fixed income letter

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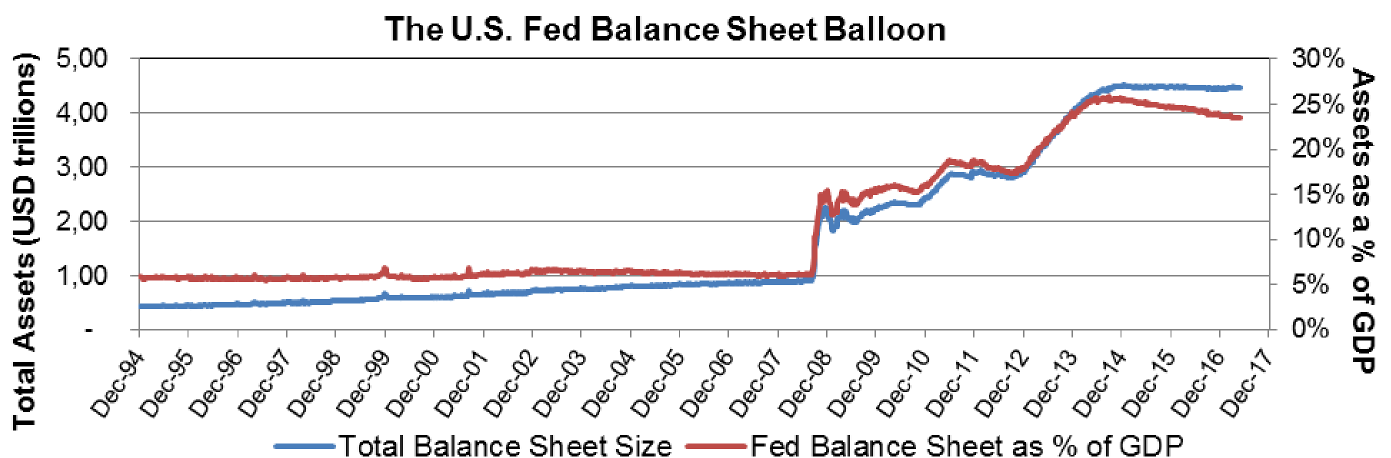
editorial

Key allocation themes across our strategies

ATTACKING THE BALANCE SHEET

Across the globe, developed market central bank balance sheets have been expanding since the Global Financial Crisis. The U.S., Euro area, and Japan central banks' balance sheets have more than tripled in size and have increased from a 12% average nominal GDP in 2007 to 28% today. The ECB and BoJ will likely continue to expand until at least mid-2018. The U.S. Federal Reserve is preparing the market for a balance sheet withdrawal, or "normalization", expected to start in late 2017. **A key question facing the market is how will the reduction in central bank balance sheets affect the ongoing recovery?**



Source: US Federal Reserve. As of May 31, 2017.

In order to answer this question, we need to study, among other things: a) the Fed's plan and communication on its exit strategy which includes broader signaling to financial markets, b) the pace at which the balance sheet will shrink, c) the sequence and prioritization of balance sheet reduction versus interest rate hikes, and d) the new "optimal size" of the Fed's balance sheet.

So far the Fed has communicated its plans for balance sheet shrinkage well without negatively affecting markets significantly. In the most recent FOMC meeting minutes, two things were apparent. First, all of the policymakers are in favor of balance sheet reduction, which is expected to start this year. Second, the reduction approach will be managed in a gradual and predictable fashion that could be adjusted if data dictates. As noted in the May 2017 minutes, "the process of reducing the Federal Reserve's securities holdings, once begun, could likely proceed without a need for the Committee to make adjustments as long as there was no material deterioration in the economic outlook."

In addition, the Fed has indicated thus far that balance sheet reduction is subordinate to interest rate normalization. While it remains possible to see both balance sheet reduction and a rate hike starting in tandem—a double whammy of tightening of financial conditions —it is more likely the Fed will give the market and the economy time to digest the announcement of the policy change.

The optimal size of the balance sheet is a subjective matter, but there is a strong argument that the optimal size is not radically smaller than it is today given the need to implement monetary policy by current methods, and given the public's demand for currency—a liability that requires assets on the balance sheet.

Given these considerations, **the reduction in the U.S. central bank's balance sheet is unlikely toaffect the economy in a significantly negative manner.** Since the crisis, the Fed has maintained its data dependency mantra, and negative externalities may be quickly considered as the basis for policy modifications. It is important to note that the balance sheet shrinkage is occurring at a time when private sector debt is increasing and, as a result, the balance sheets of commercial banks will likely expand with credit creation. Policy stimulus is being removed in a counter-cyclical fashion, as it should be. To be sure, there are risks related to the balance sheet reduction as this is uncharted territory. Most directly, retraction of stimulus could lead to the opposite of stimulus—heightened volatility and risk premia.

For now, U.S. Treasury yields look rich given the prospect of a new supply/demand imbalance given the balance sheet reduction. U.S. corporate and housing credit remains reasonably valued with room for yield spread tightening during this new phase of monetary policy tightening.

Dan Dektar

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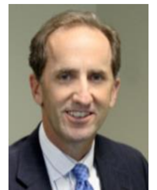

	Global Allocation					
	- -	-	=	+	+ +	No view
GOVIES / Duration						
Duration		No change				
Curve			No change			
Inflation				No change		
INVESTMENT GRADE CORPORATE						
				No change		
HIGH YIELD CORPORATE						
			No change			
EMD						
Hard Curr				No change		
Local Curr				Upgrade		
Corporate				No change		
SECURITIZED US						
Government MBS		No change				
Non-Government				Upgrade		
FOREX						
EUR			Upgrade			
USD					No change	
GBP		No change				
JPY		No change				
EM				No change		

	Flattening			Steepening		
Curve	- -	-	=	+	+ +	No view
Euro		Upgrade				
US			No change			

- -	Strong UW
-	UW
=	Neutral
+	OW
+ +	Strong OW
x	No view
(red)	Downgrade
(green)	Upgrade
(blue)	No change

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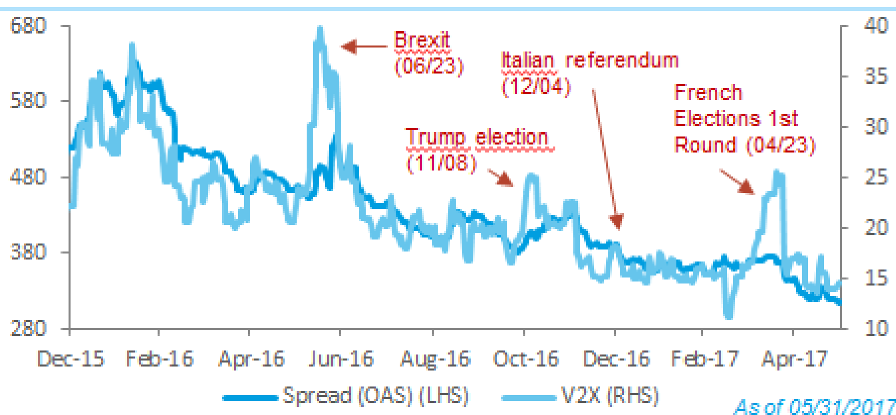
Still searching for yield

Over the past months, European HY has been steadily grinding tighter, with spreads 80bp lower year-to-date of which nearly 60bp since the first round of the French presidential election at the end of April. As highlighted on the chart below, no political event has derailed the European HY positive trend while volatility peaks (V2X) were limited and short-lived.



Though valuations seem tight in absolute terms with Yield To Weight at 2.9% and spreads around 310bp (near the lows of 2014), several factors should remain supportive for the asset class over the coming months. Indeed, the current macro environment characterized by a relatively low growth / low core inflation is favorable. It should lead the ECB to remain accommodative and keep interest rates at low levels. In addition, it would prevent HY companies from pursuing overly aggressive financial policies. As they have also benefitted from notable low refinancing conditions over the past years, default rates are unlikely to increase in the short term and should stand below average, i.e. around 2%.

On top of that, technicals should continue to be strong. Despite limited inflows in European HY open-ended funds year-to-date, the asset class keeps on benefitting from the ECB's Corporate Bond Buying program (CSPP) as IG investors in search for yield are dipping further down the rating spectrum. It is worth noting that despite the ECB's decision to reduce its QE program from €80bn/month to €60bn from April, it has been at the expense of PSPP rather than CSPP. Finally, the modest level of net issuance in the European HY market - as many issuers have already refinanced and as competition from loans, particularly attractive for issuers, is strong – tends to be supportive of secondary prices.

Taking into account the positive momentum which started after the first round of the French presidential elections, we have increased the beta of our portfolios from 1 to 1.10. We have implemented extension trades on some issuers with large capital structures, considering that curves are quite steep at this stage. We continue to focus on BB/BB- in the secondary market as they can offer more upside than some Bs, the performance of which is capped by short-term calls. Bs are more attractive in the primary market, on which we remain selective in order to avoid specific risk. Further, we have maintained our positions on Corporates Hybrids and CoCo's in particular, which are still offering attractive yields compared to corporate bonds.

Marie-Anne Allier

Head, Euro Fixed Income
Paris

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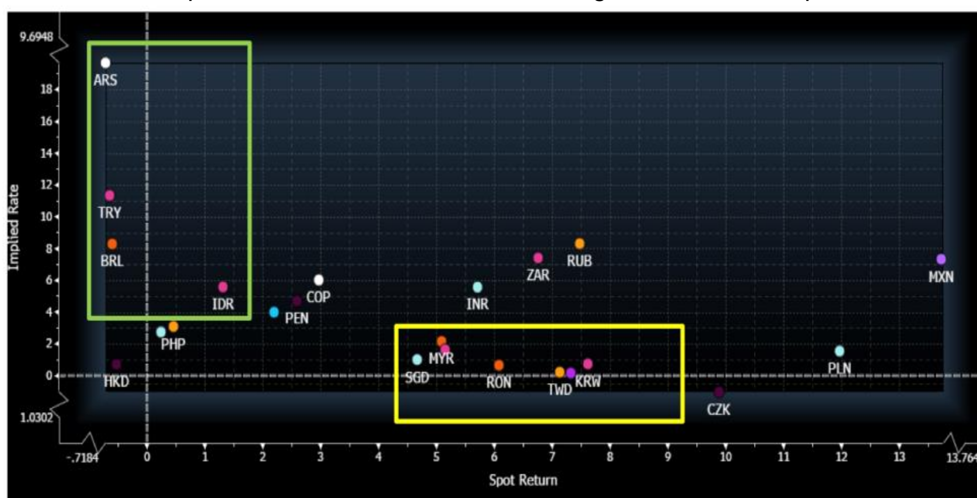
Buy those low yielders

"It's the economy, stupid" as James Carville, Bill Clinton's campaign strategist back in 1992, would have said and this year that too can be said of the performance of the low yielding Asian currencies.

The common "carry trade" performance in FX was reversed this year with low yielding Asian FX significantly outperforming the higher yielding EM ones. The Korean Won, Taiwanese Dollar, Malaysian Ringgit and Singapore Dollar, which all yield less than 1% (3m implied forward), managed to beat the Turkish Lira, Brazilian Real and Indonesian Rupiah which yield anywhere up to 11.5%.

As the chart shows the low yielding currencies highlighted in yellow show their much higher spot returns compared to the high yielding currencies highlighted in green. The low yielders returned between +4.6% to +7.5% clearly beating the Turkish Lira and Brazilian Real return of -0.4% to -0.6%. Their performance was comparable to some of the other high yielders of +5.8% in the Indian Rupee and +8.0% in the Ruble.

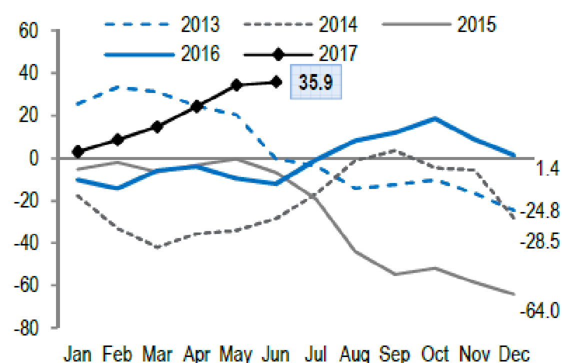
Year to Date Spot Returns of Asian and EM FX against their 3m Implied Forward



Source: Bloomberg

Why is this? The economy or to be precise the stock market. This year the positive growth and stock market performance attracted large EM equity flows which have exceeded EM bond flows. The below chart shows (black line – 2017) the annual cumulative EM equity flows and this year already exceeds the annual flows back to 2013 (the year of the Taper Tantrum). In spite of low yields, equity investors have continued to direct investments towards EM equities and this have helped the low yielding currencies where stock markets in Taiwan and South Korea have benefited significantly from the tech cycle.

Exhibit 20: Annual cumulative EM equity flows



Going forward the re-emergence of various portfolio flows will be a key driver to FX performance than the usual carry trade. To all of us global and EM bond investors, watch those equity buy recommendations with more care!

Philip Chow

CIO Amundi Singapore

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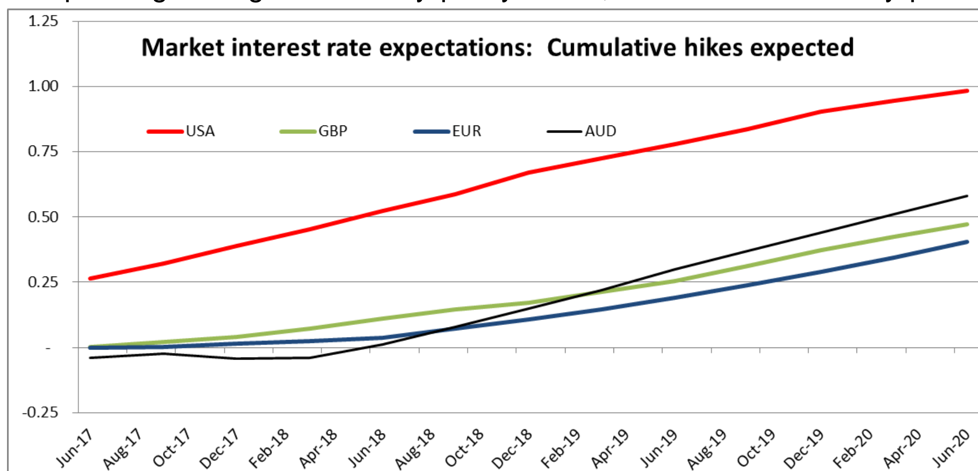
Low volatility: central banks hold the key

2016 was a year of surprises. From Brexit to the US election; from fears of deflation to "Trump reflation"; market sentiment shifted from fear to greed over 2016 helped by dosages of central bank easing and expectations of US fiscal stimulus. Perhaps one key surprise this year is the absence of market volatility despite the demise of Trump reflation trades, gradual withdrawal of central bank stimulus and plenty of idiosyncratic risks from Brazilian politics, bail-in of a second tier Spanish bank and a worrying intensification of the Saudi-Iranian rivalry over the last month. A key factor that has helped suppress volatility is that inflation and wages remain low, allowing both the US and Eurozone central banks to be exceedingly gradual in how they communicate the normalisation of monetary policy.

June's European Central Bank meeting was a case in point. In light of strong business surveys, and improving loan and labour market data the ECB raised their expectations for growth over the next two years. However, lower oil prices coupled with subdued core inflation and wage data, meant that they lowered their inflation forecast. The market's clear conclusion is that the likelihood of a surprise pre-emptive tightening in monetary policy is low, the ECB can be very patient in communicating any changes far in advance. And the pace of normalisation will be very slow.



This environment of solid growth, low inflation and the absence of any monetary policy shocks is good for risk assets. In our global bond portfolios this translates into overweight positions in both developed and emerging market credits.

However, valuations mean interest rate strategy is more ambiguous. As of 8-June, markets expected the US Federal reserve to raise rates by around 0.67% over the next 18 months; in contrast the Fed's own forecast is for rates to be raised by around 1.25%. In Europe, the market expects the first 0.25% hike in late 2019. Interest rate exposure is always a useful hedge for more risky assets. But central banks are slowing normalising monetary policy, not trying to tame inflation. So unless one expects a recession, the bar to higher interest rates, particularly in short dated maturities, is low.

This leaves us with a global bond strategy that generates an attractive yield from developed and emerging market credit, particularly bonds with good potential for capital gains. In contrast, we are underweight duration with a preference for owning longer dated yields that offer more risk premia and hence are a better hedge for risky assets.

Laurent Crosnier

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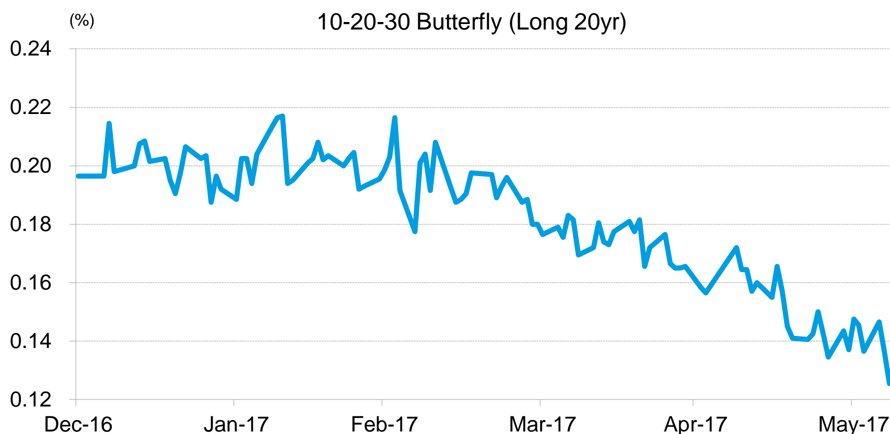
Strategy in Tokyo

As we discussed in recent months, the BOJ's unconventional policy, YCC ("yield curve control"), has successfully contained 10 year JGB within a very narrow range of 6 bps, and consequently the 20 year and 30 year JGB within 7 bps and 5 bps, respectively. However, the reduction in the total amount of the JGB purchase programme affected the shorter end of the curve, pushing 2-year JGB up by 10bps and 5-year JGB up by 8 bps.

Though our leeway for establishing positions focusing on the shape of the curve is gradually narrowing, the JGB curve still provides opportunities to introduce positions based on relative value analysis.

- Maintained relative value positioning based on yield cushion analysis: long 2-, 7-, 10- and 20 year at the cost of deep short position in the 5- and 30-year.
- Maintained 10-20-30year butterfly (long 20 year and short in the 10 and 30 year) which generated strong returns.
- Maintained BEI position instead of taking some steepening positions in the 2- to 5-year buckets



We saw a huge amount of corporate bond issuances in May. Some of those issuers were very ambitious with respect to minimising financing costs, so much so that these issuances were deeply undersubscribed. This may be the signal of a change in the credit market trend. Although the BOJ is still supporting the corporate bond market through the corporate bond purchase programme, we may have to be a little more cautious about the Japanese credit market.

- Still overweight in the shorter end of the Japanese credit sector while maintaining weighted duration of credit portfolio neutral.

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

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