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Fixed Income: Zero rates do not mean zero returns

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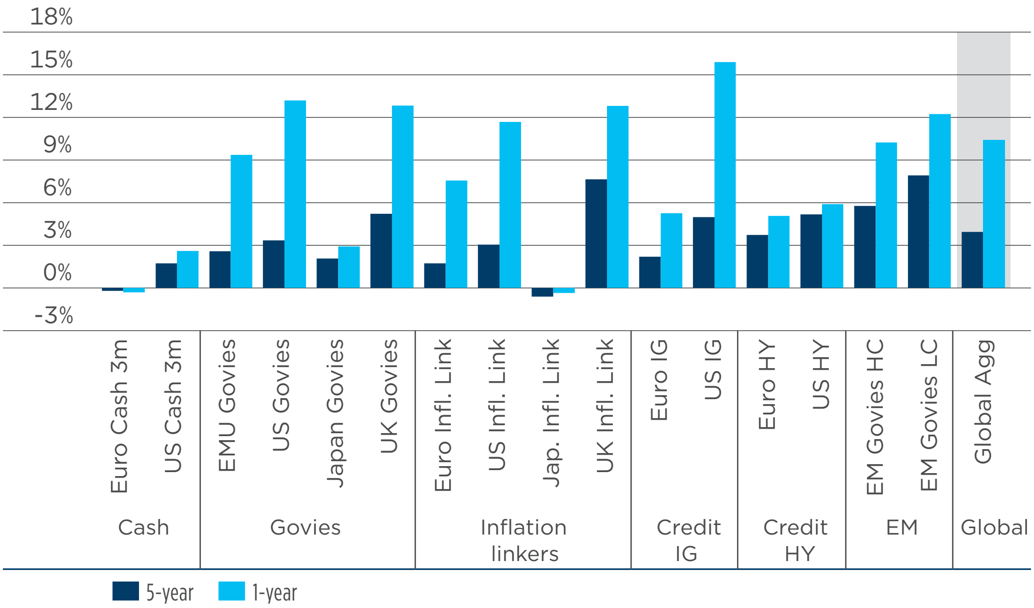
As we enter the 2020s, a look back over the previous decade provides a key take-away for investors: **a zero-rate environment does not lead to zero performance for bond investors**. Last year was a clear example as bond markets delivered strong performances with almost – if not above – double-digit returns across the board. Looking back over the past five years, annualised returns across different bond markets were also positive. The Bloomberg Barclays Global Aggregate USD-Hedged index delivered 8.7% in 2019 and an average of 3.5% over the past five years.

Figure 1. One-year vs. five-year annualised returns, as of 28 February 2020

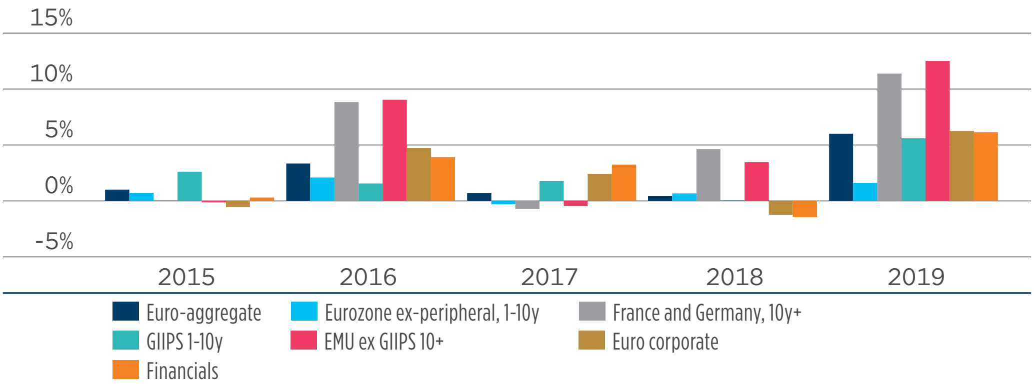


Source: Bloomberg, Amundi. Data as of 2 March 2020. **Paste performance is no guarantee of future results.**

"Despite a zero-rate environment, there are multiple engines at work in global and Euro fixed income that may deliver attractive returns."

Notably, the Eurozone government bond space delivered positive performances despite the negative ECB deposit rate having been in place since 2014, as different factors drove performances at different times, including the higher yields warranted by peripheral bonds, the safe-haven lure of core bonds and credit spread trends.

Figure 2. Returns across segments of the Euro fixed income market, 2015-19



Source: Bloomberg, Amundi. Data as of 2 March 2020. GIIPS: Greece, Ireland, Italy, Portugal, Spain. **Paste performance is no guarantee of future results.**

The accomodative shift by global central banks was the main market theme of 2019 and it is confirmed in 2020. The Federal Reserve cut official rates three times in 2019 after having hiked four times in 2018. It also cut rates in an emergency move on 3 March 2020 and the Federal Funds target rate now stands below its estimated neutral level. Meanwhile, the ECB restarted its quantitative easing (QE) programme.

We enter the 2020s with still very low rates and with some tightness in credit markets after last year's rally, partially reduced after the recent market sell-off induced by the coronavirus outbreak. We still believe that fixed income may offer room for active managers to deliver attractive performances on the basis of **five themes**:

1. GO ACTIVE to navigate the 'LOWER FOR LONGER' interest rates environment;
2. PLAY RELATIVE-VALUE STRATEGIES in government bonds;
3. SELECT CREDIT IDEAS, with DEMAND even stronger than record SUPPLY;
4. CAST THE NET WIDE in search of pockets of VALUE; and
5. RIDE the 'GREEN WAVE'.

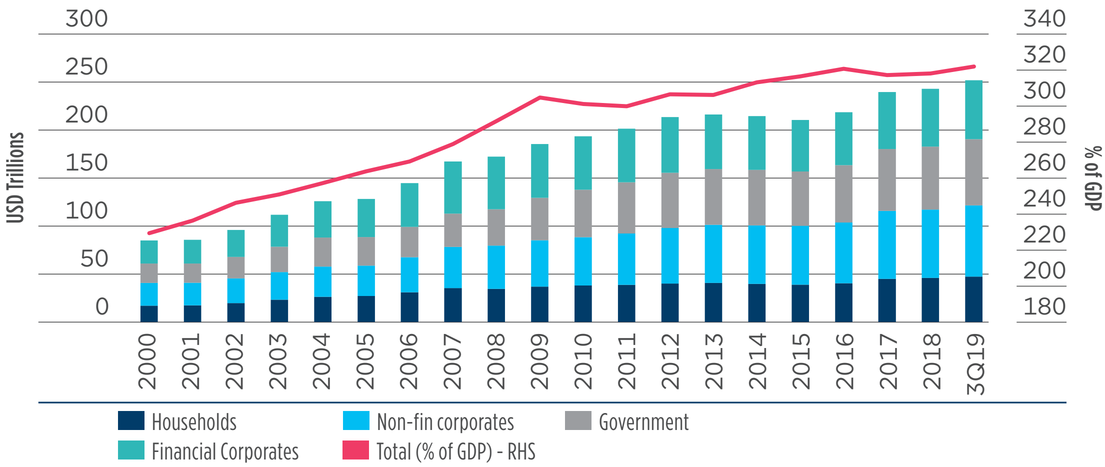
1. GO ACTIVE to navigate the 'LOWER FOR LONGER' interest rates environment

"Low interest rates have structural roots, stemming from excess savings and lower potential growth, which may affect monetary policy for several years."

Low interest rates are an economic end-of-cycle phenomenon but also have structural roots, stemming from **excess savings and lower nominal potential GDP growth, which may affect monetary policy trends for several years**.

In detail, nominal potential growth is trending lower on both its components: real potential growth and inflation trends. The former is being hit by adverse demographics impairing labour force dynamics, while inflation is subdued for multiple structural reasons, including technological progress, globalisation and low wage gains. As equilibrium growth trends down, neutral interest rates will also be lower than in the past, favouring the pile-up of global debt (both private and public), which has surged to unprecedented levels. According to the Institute of International Finance, in September 2019 global debt of all sources (government, business and household) totalled 253 trillion USD, up 9 trillion USD from the beginning of the year. The global debt-to-GDP ratio is also at a record high (322%) as many governments and corporates have increased their borrowing to take advantage of low rates.

Figure 3. 'Lower for longer' rates in a world washed by debt (total debt by sector)



Source: IIF, Amundi. Data as of 2 March 2020.

For the above reasons, monetary conditions will remain loose for an extended period of time and **financial repression is likely to dominate markets throughout the early 2020s. Such an environment will be supportive across all maturities of the government curves**. In the short term, in response to the coronavirus emergency, **a new wave of monetary policy easing is expected with multiple tools at play and including rate cuts already delivered by the Fed, QE extension by the ECB and new schemes to address liquidity crunch risks**. Beyond the short term, we expect:

- **Eurozone** core government bond yields should remain at about zero – or below — for some time. The ECB may not be able to exit its QE programme and unconventional monetary policies may become conventional ('**QE infinity**');
- **Upward pressure on US Treasury yields should be limited**, as US growth is decelerating towards potential and the inflation outlook is benign;
- EM rates should provide attractive carry opportunities compared with DM, with some potential for further rate reductions in the medium term.

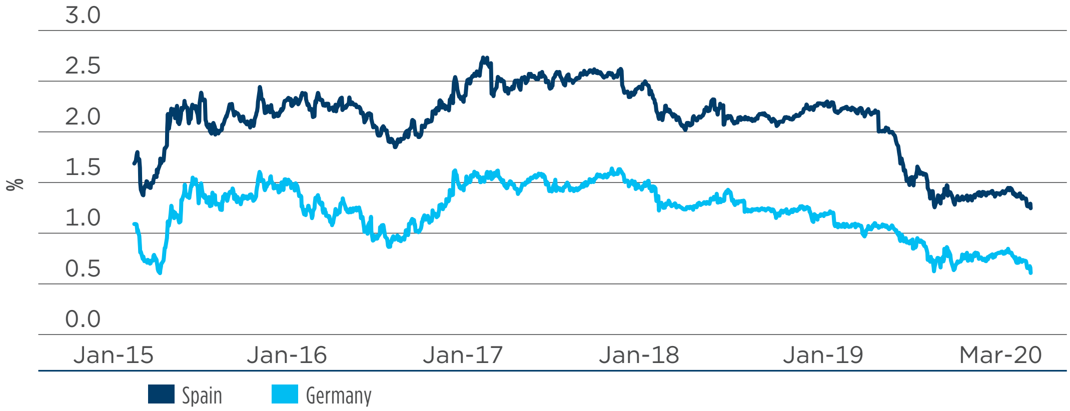
"Performance generation will be a game of relative-value play across segments, curves, regions and sectors."

Overall, fixed income markets are unlikely to suffer from large upward movements in rates, while at the same time a further market rally is also unlikely. As a result, **performance generation will be a game of relative-value play across segments**, curves, regions and sectors, which bodes well for flexible and active global asset managers with expertise across the full spectrum of bonds markets. It will also be a **story of playing entry points in case of possible market disclocations**, as it is the case now with the coronavirus-induced spread widening in credit and government peripheral bond markets.

2. PLAY RELATIVE-VALUE STRATEGIES in government bonds

Such a low-rate environment might be perceived to offer a lack of opportunities in government bonds markets. However, this is not the case and **investors could benefit from positive carry and performance opportunities even with negative interest rates**. For instance, they may short negative-yielding bonds (e.g., German Bunds) to gain a positive carry and as a hedge against possible upward shifts of the curve. **Investors could generate performance by adopting a flexible duration approach**. Even if rates are likely to remain low due to structural conditions, they will not be completely static. There may be mini-cycles of rising/falling rates, depending on the strength of the economic cycle (pressure on yields) and the geopolitical risks (demand for safe-haven assets). Investors could benefit by adopting active duration management, where the risk of being short duration is likely to be asymmetric, as many downward forces play on rates. Finally, active managers can apply **relative-value strategies to play yield curve movements**. This includes **buying and selling bonds with different maturities to exploit opportunities arising from changes in the shape of the yield curve** (e.g., the German vs. the Spanish government yield curve). On yield curves, we favour curve-flattener positioning as demand for safe assets will push long-term rates down and steepener positioning on the UK Gilt curve ahead of the EU-UK trade talks. A solid macroeconomic and strategy research team and an experienced portfolio management team are vital in exploiting such opportunities.

Figure 4. 5 to 30-year government bond yield spread, Germany vs. Spain



Source: Bloomberg, Amundi. Data as of 2 March 2020.

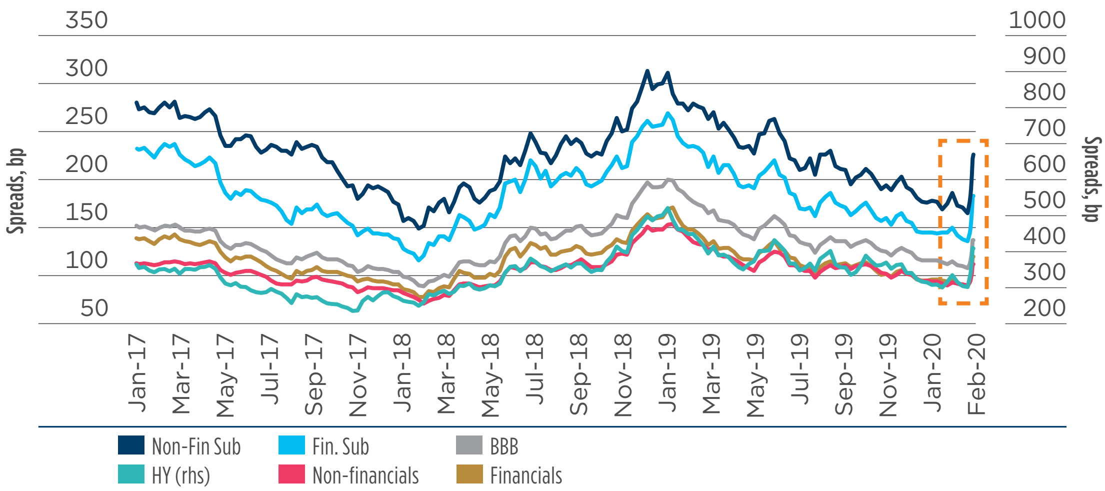
3. SELECT CREDIT IDEAS, with DEMAND even stronger than record SUPPLY

"We see room for further spread compression in corporate bond markets, moving down the rating spectrum and amid falling dispersion."

Despite the strong performance of the past decade, there is still room for possible spread tightening in corporate bond markets. As for yields, despite the spread compression trend helped in the Eurozone by the ECB through its **corporate sector purchase programme (CSPP), which will also help containing volatility within the asset class**, there can also be phases of spread widening like the one we are experiencing now with the emergence of coronavirus outbreak.

These movements can generate entry points for adding to credit exposure at more attractive spread levels, opportunities that active managers can exploit benefitting from a research-intense approach.

Figure 5. Euro credit spread trends



Source: Bloomberg, Amundi. Data as of 2 March 2020.

"A dedicated credit research team can help select corporate issues with the best risk/return profile and avoid stories sensitive to deteriorating economic conditions."

In the corporate bond market, both fundamentals and technicals remain supportive. Under a macroeconomic scenario of growth stabilisation, after the temporary slowdown induced by the coronavirus epidemic, corporate bonds could still generate positive performance. In Europe, corporate fundamentals are generally healthy and stable, with limited leverage, while US corporates are more leveraged in a context of economic deceleration. With very low government bond yields, credit markets will be back in focus as soon as the situation on coronavirus normalises. However, high selectivity will be required. **Technicals also bode well**. Despite strong corporate issuance – especially within euro IG issuers – primary books have generally been oversubscribed as cash-rich investors seek opportunities in fixed income. In 2019, more than 2.5 trillion USD of corporate bonds were issued globally, a new record and about 25% above 2018 issuance, according to Dealogic data. As confirmation of the strong demand from investors, net sales of fixed income open-ended funds totalled more than 200 billion EUR globally over the first 11 months of 2019, according to Broadridge data and our own calculations. With core government yields falling to new all-time lows, the **search for yield will remain a dominant theme in the market in 2020 and beyond**. Good quality issuers that offer an extra yield compared with the risk-free rate will remain in strong demand and any spread widening could become a buying opportunity.

High selectivity and scrutiny will be key in bond-picking activity over the next few years to avoid overcrowded trades and invest in securities that will hold well in case of any deterioration of economic conditions. In this respect, **a dedicated credit research team can be helpful**, as credit analysts:

- perform single-name analysis to anticipate distressed credit situations and mitigate the downgrade risk (particularly the 'fallen angels' risk of issuers being downgraded from IG into HY territory);
- perform sector analysis to avoid concentration in distressed sectors; and
- support investments with a bond screening aimed at selecting those corporate issues with the best risk/return profile.

4. CAST THE NET WIDE in search of pockets of VALUE

Other segments of the global fixed income market that, we believe, could offer additional income opportunities for the early 2020s. These include:

- **High-yield and financial subordinated bonds** may offer appealing yields. EU HY enjoys healthier fundamentals than US HY, including lower leverage and the smaller share accounted for by the troubled energy sector. As such, US HY could offer larger return opportunities but requires more research and selectivity than EUR HY. European financial subordinated bonds could offer good return opportunities for highly rated issuers. The European banking sector has undergone huge reforms since the global financial crisis and now appears more solid than in the past. As investors take on more credit risk to boost portfolio returns, **selectivity, quality and diversification** will be vital in corporate bond investing in the early 2020s, especially when digging deep into **HY territory to search for income**.
- **Securitised assets**, which are financial instruments where cash flows are derived from and secured by specific underlying collateral. Securitisations may include bonds backed by residential mortgages, commercial mortgages, automobile loans, credit cards and bank loans made to corporations and other assets. Securitised assets were at the epicentre of the 2008 global financial crisis, especially in the United States. Since then, consumer balance sheets have been cleaned up and market reforms have been implemented. In Europe, ESMA's Securitisation Regulation adopted in 2017, has made such asset classes more transparent and much safer than was the case in 2008. Therefore, we believe **securitised assets may now be better placed to deliver an additional source of return, if well scrutinised**.
- **Emerging market debt**, resilient amid subdued inflation, overall limited geopolitical tensions and a neutral/dovish stance from central banks. EM debt offers attractive carry and benefits from low issuance, though caution is needed in the short term after the strong performance of 2019 and with the coronavirus fallout, which needs close monitoring. We expect central banks to continue their monetary easing in countries where inflation is under control and **therefore real yields in local currency bonds are likely to remain attractive**.

"EM debt offers attractive carry and benefits from low issuance, though caution is needed after the strong 2019 performance."

Focus: Detecting value in credit markets

In a still rich-valuation environment despite recent spread widening, the ability to extract value – wherever available – will be critical. Below we propose a framework for assessing value in the European and US corporate bond markets – including both IG and HY bonds, based on a number of indicators.

Table 1. Assessing value in US and EU corporate bond markets (1-to-5 scale, 1 being the richest and 5 the cheapest)

Valuation metrics			United States	Europe
Fundamentals	Macroeconomic	ISM/PMI	2.0	3.0
	Corporate	Financial leverage	2.0	3.0
		Interest coverage	3.0	3.0
Risk sentiment	Equity implied volatility	VIX/VSTOXX	2.0	2.0
Financial conditions	Bank lending standards	ECB/Fed bank lending surveys	3.0	3.0
Historical standards	Long-term spreads		2.5	2.5
Spread to global govies			3.0	2.0
Average valuation			**2.5**	**2.6**

Source: Amundi. Data as of 3 March 2020.

In detail, we build our judgement on a set of different metrics that allow us to define market value in a comprehensive way.

"Comparing corporate with global government bond yields, valuations appear slightly cheaper in Europe than in the United States."

Regarding fundamentals, the US market is currently more expensive than the EU market, as a regression of corporate spreads against the PMI/ISM level shows that US spreads are tighter and lie far below their long-term trend. The same holds true at the micro level, regarding financial leverage, as US corporates are generally more indebted than their European counterparts, while the interest rate coverage – a measure of a corporate's ability to meet its interest payments – delivers the same valuation for both areas.

In addition, equity market volatility as a measure of risk sentiment gains the same valuation across both markets – it may decrease over the next few days after coronavirus-related fears subside and the emergency Fed rate cut becomes effective -- and bank lending standards are basically neutral in both areas.

On a historical perspective, long-term spreads are tighter than their historical average in both markets, leading to equally rich valuations on this metric. However, **comparing corporate with global government bond yields, valuations appear slightly cheaper in Europe than in the United States**. Corporate bond yields are actually lower in Europe than in the United States on average, but this mainly reflects the lower sovereign bond yields in Europe than in the United States.

In the end, in relative-value terms we believe there is currently more value in EU corporate bond markets, but, in absolute terms, the US market still offers appealing diversification opportunities to global fixed income investors.

5. RIDE the 'GREEN WAVE'

"A 'green wave' could be one of the main features of the fixed income market in the 2020s and the ability of asset managers to ride this trend will be key for future performance."

Over the next decade, bond investors will have to consider other structural themes, such as rising inequality, climate change and the transition to clean energy sources. The size of the ESG market is currently estimated at about 30 trillion USD globally and is expected to grow towards 125 trillion USD by 2030; the ability of asset managers to integrate ESG principles into portfolio management will thus be increasingly relevant, and such criteria need to be considered as a key investment driver. According to recent Amundi research, the correlation between the inclusion of ESG criteria and portfolio performance seeems to be positive and rising, showing that ESG could now be considered a key investment decision driver.

ESG criteria are also being integrated into credit rating methodologies and play an increasingly relevant role in the assessment of fixed income instruments. Consequently, some **correlation patterns between ESG and credit ratings are emerging**. In order to highlight the value provided by the integration of ESG research into the investment life cycle, a few capabilities need to be factored in, including:

- ability to explain ESG rating methodologies clearly;
- articulating ESG ratings within credit analysis;
- assessing the impact of ESG ratings on credit quality; and
- reporting the above factors to investors.

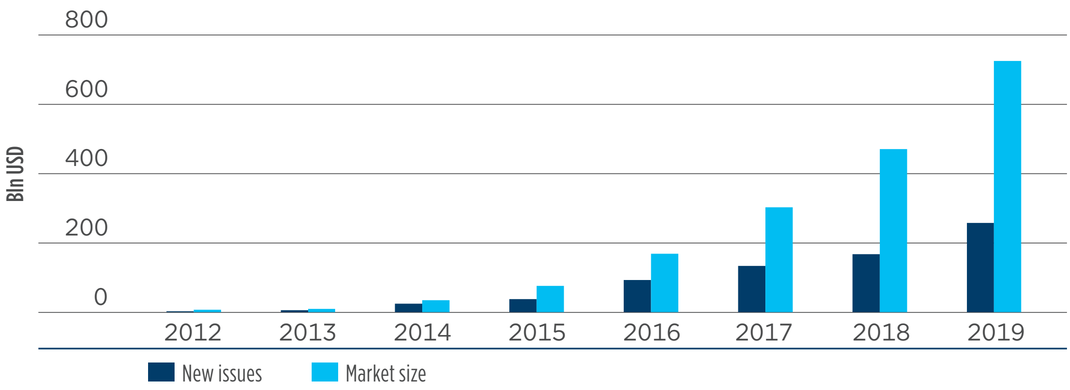
ESG integration is now assessed by investors both as a potential driver of financial performance and for its impact on each of the three pillars (environmental, social and governance). **Therefore, ESG integration should not be limited to credit analysis but has to be extended to the investment policy through a comprehensive approach of each of the three pillars. The immediate goal in this regard is gaining a better ESG portfolio score than the benchmark, complemented with an exclusion policy on each of the three pillars**.

"On ESG there is no turn back, as its integration is a matter of fiduciary duty for both asset managers and investors."

When selecting asset managers, investors increasingly scrutinise their ability to complement financial performance with a positive ESG impact, which has become a key decision driver for investment purposes. **Therefore, ESG integration is now a matter of fiduciary duty between asset managers and investors**.

Such trends may open up opportunities in some asset classes, including **green bonds**. Last year was a record year for the green bond market: at the end of 2019, the size of the green bond market totalled more than 700 billion USD, with record issuance over the year (255 billion USD). This year, new issuance is forecasted to rise further to 350 billion USD, according to the Climate Bonds Initiative.

Figure 6. Green bond wave



Source: Climatebonds.net, Amundi. Data as of 2 March 2020.

As the world intensifies its efforts to fight climate change, green bonds are a vector of choice to fulfil this goal and their potential is rising. Such potential might become even higher in the future: as ECB president Christine Lagarde recently announced the first comprehensive monetary policy review since 2003, the chance that green bonds may be included in the central bank's QE programme is rising. The review is expected to be concluded by the end of 2020 and it could provide further appeal to this asset class.

Green bonds could increase market-driven demand for improved ESG disclosure by companies and financial institutions. This will have a tangible knock-on benefit in facilitating sustainable finance across a range of asset classes and financial products. It also enhances the ability of regulators to assess ESG risks and green finance flows at the market level, enabling them to structure regulation and provide incentives to drive more capital to sectors with high environmental and social benefits. **A 'green wave' could be one of the main features of the fixed income market in the 2020s and the ability of asset managers to ride this wave will be key to broadening the opportunity set**.

Take-aways: rethinking fixed income investing in the early 2020s

"Incorporating ESG filtering is not only a way to improve the ESG impact, it will also be a source of potential performance enhancement."

If, after the economic setback of the first part of the year, our base scenario of stabilisation is confirmed for the second half of 2020, the positive fixed income cycle is likely to continue and there will be room for **active managers to again seek good performances in 2020**.

Investors with a **high degree of flexibility should be able to adjust their exposure to fixed income markets exploiting entry points** that can materialise throughout the year. In addition, the ability **to blend an appropriate mix of relative-value strategies** across all market segments and geographies provides a competitive advantage in this market environment.

We are **mindful of areas of risks** (high leverage in US HY, loans and CLOs) as the credit cycle extends and there are some clouds in the economic outlook. This translates into an **even higher focus on credit selection**. A solid credit research set-up and a sound risk management framework are paramount to mitigating downside risks.

In a late-cycle environment with accommodative central banks which stand ready to act to preserve financial stability, **liquidity should remain ample at the macro level, providing investors with flexibility**. However, despite high macro liquidity levels, liquidity may dry up in single markets during times of financial stress. In fact, following the GFC, changes in regulations have resulted in a reduction of bank and dealer activity in the United States at a time when the credit market's size has increased significantly, especially in the less liquid HY segment.

Therefore, we believe that market liquidity will be a key factor that needs to be included in the investment decision-making process to protect potentially investors against deteriorating conditions and rising idiosyncratic risks.

Finally, we strongly believe that incorporating ESG filtering is not only a way to improve the ESG impact, but that it will also be a source of potential performance enhancement.

Definitions

- **ABS:** Asset-backed securities. These are financial securities such as bonds, which are collateralised by a pool of assets, possibly including loans, leases, credit card debt, royalties or receivables.
- **Alpha:** The additional return above the expected return of the beta-adjusted market return; a positive alpha suggests risk-adjusted value is added by the money manager compared with the index.
- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Beta:** It is a measure of the overall systematic risk of a portfolio of investments.
- **Bond ratings:** (Source: Moody's and S&P). If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in a portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **Carry:** The carry of an asset is the return obtained from holding it.
- **Correlation:** The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **CSPP:** Corporate sector purchase programme, part of the ECB's asset purchase programme.
- **Curve flattening:** A flattening yield curve may be a result of long-term interest rates falling more than short-term interest rates or short-term rates increasing more than long-term rates.
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **Default rate:** Share of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofAML indices. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indices considered for the corporate market are ICE BofA Merrill Lynch.
- **Diversification:** Diversification does not guarantee a profit or protect against a loss.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **ESG:** Environmental, social and governance.
- **ESMA:** European Securities and Markets Authority.
- **MBS, CMBS, ABS:** Mortgage-backed security (MBS), commercial mortgage-backed security (CMBS), asset-backed security (ABS).
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Senior and subordinated debt:** Subordinated debt is any type of loan that is paid after all other corporate debts and loans are repaid (senior debt), in the case of borrower default. The senior debt takes priority; it is more secure than any other debt.
- **Spread:** The difference between two prices or interest rates.
- **Term premium:** The difference between the yield of a longer-maturity bond and the average expected risk-free short-term rate for that maturity.
- **TLTRO:** The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions for a predefined period. They offer long-term funding at attractive conditions to banks in order to further ease private sector credit conditions and stimulate bank lending to the real economy.
- **Two-tier/tiering system of ECB:** A mechanism that allows banks to park their excess funds with the ECB. Under this, a portion of banks' deposits are exempted from negative rates.
- **VIX:** VIX is the CBOE volatility index. The VIX index is a measure of market expectations of near-term volatility on the S&P 500 (US equity).
- **VSTOXX:** VSTOXX is the Euro Stoxx 50 volatility index. It measures the implied volatility of near-term Euro Stoxx 50 options, which are traded on the Eurex exchange.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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