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Thematic paper | CROSS ASSET Investment Strategy

May 2018

Cross road: the landscape of the fixed-income market

RESEARCH STRATEGY & ANALYSIS

Cross road: the landscape of the fixed-income market

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Fixed Income and FX Strategy

Finalised on 29/04/2018

The essential

The global economy enjoyed a strongest upturn in 2017. The upswing was broad and driven by a notable rebound in global trade and an investment recovery in advanced economies. The improvement in the macroeconomic environment has allowed central banks to confirm the gradual reduction (at different speeds) in the accommodative stance of monetary policy.

This turning point signals a normalisation in fixed income markets. The "normal" relationship between growth, higher inflation expectations and higher interest rates finally seems to have been restored to some extent.

This environment calls for an active approach to fixed income: active in duration, active in currency management (as CB policies are not fully synchronised), and active in security selection in credit (overall quite tight valuations) to find the right balance between risk and reward. This also calls for enhancing sources of diversification both to hedge against inflation risk (inflation-linked bond) and to capture stronger economic growth (momentum).

I. 2018 marked a turning point

In 2017, the global economy enjoyed its strongest upturn for more than five years. All advanced economies performed better than expected, with the exception of the UK. Growth was strong in China and India, while Brazil and Russia also confirmed their exit from recession. In recent months, growth forecasts for 2018 have been also revised significantly upwards: growth is now expected to come in around 2.4% in the eurozone (vs. 1.6% expected in July 2017) and 2.8% in the US (vs. 2.3% in Sept. 2017). This very positive backdrop has allowed central banks in developed countries to reduce the accommodative stance of their monetary policies. In this new environment, what matters for the fixed-income markets? What are the game changers?

1.1 The positioning of economies in the cycle matters for fixed-income investors

The US economy is more advanced in the cycle than the eurozone economy, which implies different problems for investors.

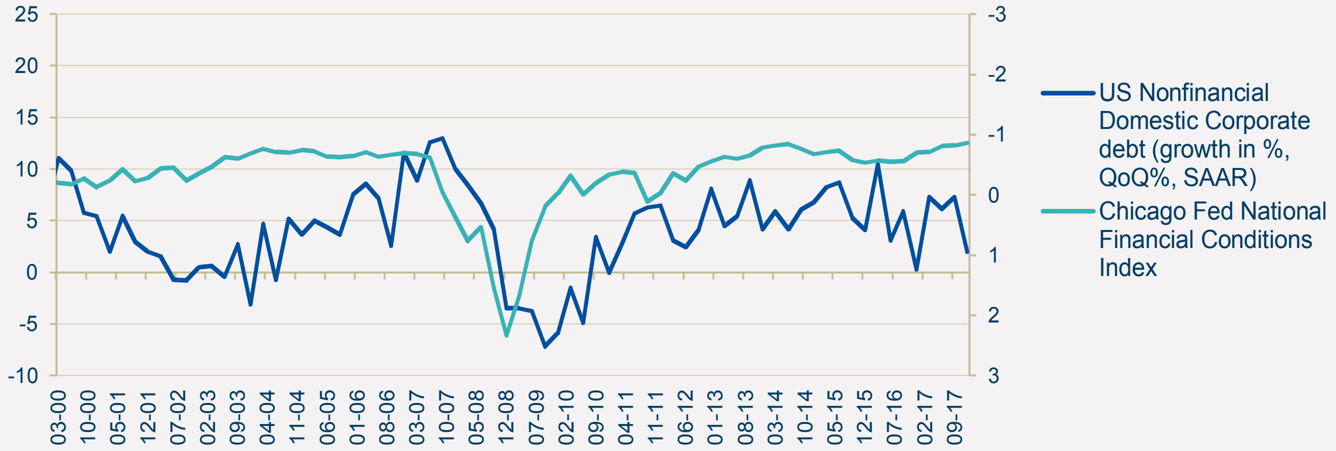
The United States economy is in the late phase of the expansion cycle. We expect growth in the US to increase to 2.9% in 2018 compared to 2.3% in 2017, supported by the tax cuts and increased federal spending. The following year, growth is expected to slow down but remain above potential. We assume a modest rise in inflation.

- Wage increases – limited at this stage – could surprise on the upside as the US economy is now close to full employment (unemployment rate at 4.1% in February).
- The sharp rise in debt has made the US economy more sensitive to

tighter financing conditions. The "low for long" interest rate environment has encouraged excessive indebtedness of US companies and US households in the consumer debt segment. Household mortgage debt remains far below previous peaks.

- For the moment, financing conditions have remained very accommodative despite the hike in Fed Funds. The central bank has already embarked on a progressive monetary tightening cycle (six rises in interest rates since 2015) and a normalisation of its balance sheet.

1/ Corporate debt/HH debt & Financing conditions



Source Bloomberg, Amundi Research

The Eurozone economy is in the mid-phase of the expansion cycle. The recovery in the eurozone intensified in 2017. Recent surveys have shown some signs of moderation but remain at quite a high level. We expect growth to remain above potential over the next two years (2018: 2.3% and 2019: 1.9%). Inflation should increase very gradually.

- The existing slack of the European labour market limits wage pressure.
- The fundamentals of peripheral sovereign countries have improved significantly recently with the pick-up in economic growth and inflation coupled with the improvement of the primary balance. Credit agencies have begun to upgrade credit ratings in a number of countries.
- European companies have behaved prudently. There is still no evidence of broad based re-leveraging across European corporates.
- The ECB will inject liquidity until September/December 2018 and will not start to raise rates before the second half of 2019. Consequently: 25% of the euro fixed-income market is still trading at a negative yield. Financing conditions remain very accommodative.

> "The ECB will not start to raise rates before the second half of 2019."

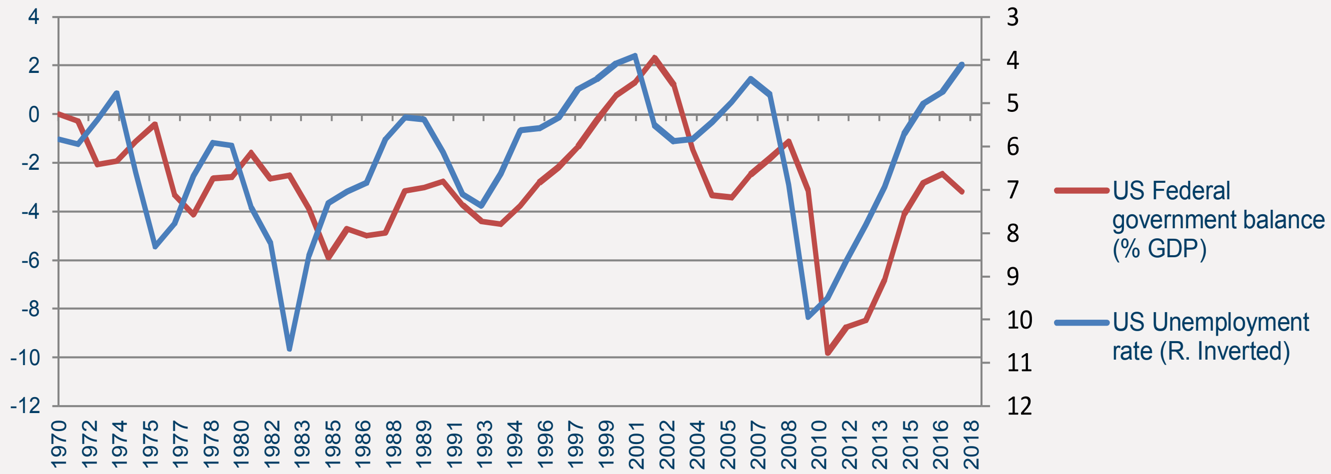
1.2 Investors are questioning the impact of Trump's tax policy and increased spending on the military and domestic programmes

Our central scenario remains a positive impact of tax reform at macro and micro levels. However, the positive impact will fade over time and the pro-cyclical fiscal policy has increased the likelihood of inflationary pressure. It is completely unusual to have a stimulus at this stage of the cycle. The risk of inflation in the US is skewed to the upside as the global output gap is expected to close this year.

Will this fiscal plan extend the US cycle?

- **The US fiscal stimulus and higher federal spending could lead to a boom and bust story.** The pro-cyclical stimulus could lead to overheating risks and could pose risks for inflation and/or financial stability. A sharper-than-expected tightening of financial conditions could affect the US cycle. Keep in mind: growth in consumer spending remains partly supported by household wealth (Real Estate, Equity) and consumer debt. The household savings rate has dropped to its lowest level since 2005.

2/ **Unemployment/fiscal deficit**



Source Bloomberg, Amundi Research

- **On the contrary, the fiscal plan could increase the sustainability of US growth.** The rebalancing of profits and wages is not necessarily bad news for the US economy. It's extremely important to understand that the growth in profits seen during this cycle has been driven more by margin growth than growth in sales. US margins are currently at all-time highs. In other words, pressure on wages has enabled corporations to increase their profits. Raising wages could – all other things being equal – increase revenue momentum. Increasing demand is essential to sustain the recovery of investment. The Capex story is key: an increase in productivity will give the economy more room to accelerate without inflation.
- **What US companies will do with their savings is key**. Businesses could use their tax savings to boost: (1) worker compensation, (2) investment or (3) shareholder returns and M&A operations. During this cycle, American companies have raised huge amounts of debt to finance M&A and share buy-back operations. At this stage, we expect a moderate rise in wages and investment. US companies will definitely remain very active in their share buy-back activities and merger & acquisition operations.

> "What US companies will do with their savings is key."

This fiscal plan will significantly widen the US government's budget deficit

- **The Congressional Budget Office (CBO) expects the government's budget deficit to widen** as spending is rising faster than revenue. The CBO projected the federal deficit will total $804bn in fiscal 2018 and $1tr in 2020, up from $665bn in fiscal 2017. A larger deficit will add to the National debt: debt held by the public will hit $28.7tr at the end of fiscal 2028 (96.2% of GDP), up from 78% of GDP in 2018. According to the CBO director: "Such high and rising debt would have serious negative consequences for the budget and the nation; in particular, the likelihood of a fiscal crisis in the United States would increase".

1.3 Trump's tariffs pose a threat to global economic revival.

Trump's protectionist policy has worried investors in recent weeks. For now, we see further controversial trade actions and noise but we do not expect to see an escalation into a full-blown trade war. However, risks appear to be increasing and partly priced in by the markets, in the FX space in particular. Europe seems off for now, although the appreciation of the euro and the perspective of slower global trade are not helpful for those countries such as Germany (think about the auto sector for instance).

The global scenario remains supportive for the markets. GDP growth is expected to come in above potential in 2019 (in most countries), albeit slightly decelerating. We expect a modest rise in inflation. Central banks should very gradually withdraw the excessively accommodative stance of their monetary policies.

We have identified two major risks: (1) a sharp tightening of financing conditions (surprise on inflation, higher risk aversion) and (2) a deterioration of trade conditions that will affect global growth.

II. Technicals in the fixed Income market will become less supportive in the coming years.

2.1 DM central banks have changed the landscape of the fixed-income market in recent years

Central banks have provided substantial support since the financial crisis to the fixed-income market via:

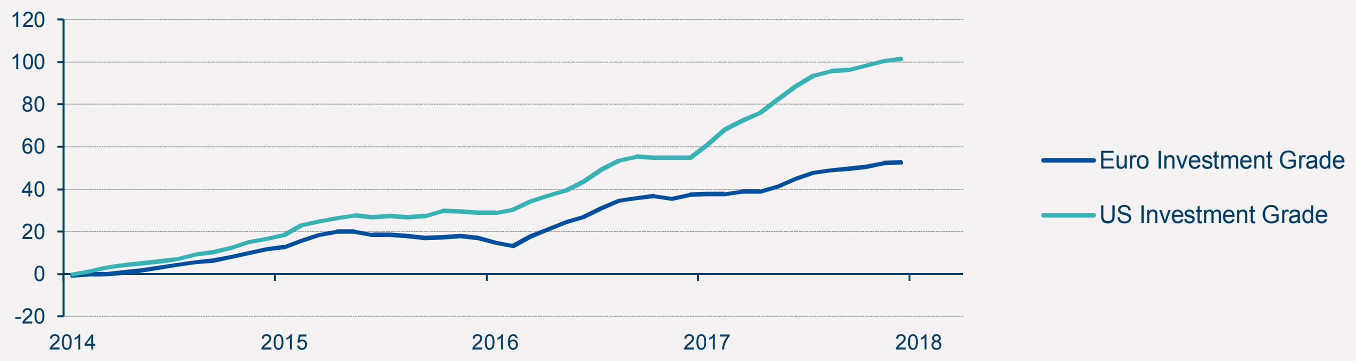
> "Monetary policies have motivated the global search for yield."

1. **Unconventional monetary policies.** These measures have aimed to stimulate activity and inflation against a backdrop where key rates were close to their lower limit and have consisted of bank loans and more specifically asset purchase programmes. Consequently:
   - The major central banks have aggressively bought government bonds. A large part of the public debt is now held by the central banks of these countries: the United States (20% or $2.432 trillion), Europe (20% or €1.913 trillion) and Japan (30% or JPY 10.46 trillion).
   - The ECB has also become an important player in the euro corporate bond market.

2. **The "global search for yield".** Monetary policies have contributed significantly to pushing sovereign bond yields down especially in Europe and Japan where negative rates were used to stabilise the economy. 15% of the global bond market is still trading at a negative return. This low interest rate environment prompted investors to turn to the markets offering the most attractive yields. The United States was the first to emerge from the crisis and raise key rates, and so the US fixed income market was considered as an oasis in this yield desert. Trends observed in recent years:
   - Strong demand for US assets by foreigners and domestic investors.
   - Strong demand for IG. Demand has increased at an unprecedented pace in recent years. In a low yield environment, foreign investors have been motivated by the search for yield: IG credit has been treated as a rate product. USD corporate securities held by foreign residents have increased by 45% since 2012 and foreign investors currently account for 40% of the USD corporate bond market.

In recent years, the bond market has benefited from a very favourable environment of low growth / low inflation / very accommodative monetary policy. Sovereign yields and corporate spreads tightened to/near record low levels. However, this environment is changing.

3/ **Flows in IG / Fixed income yield distribution**



Source: Amundi Research

2.2 DM central banks will now pull back collectively

Because of the improving growth environment, central banks are now pulling back collectively:

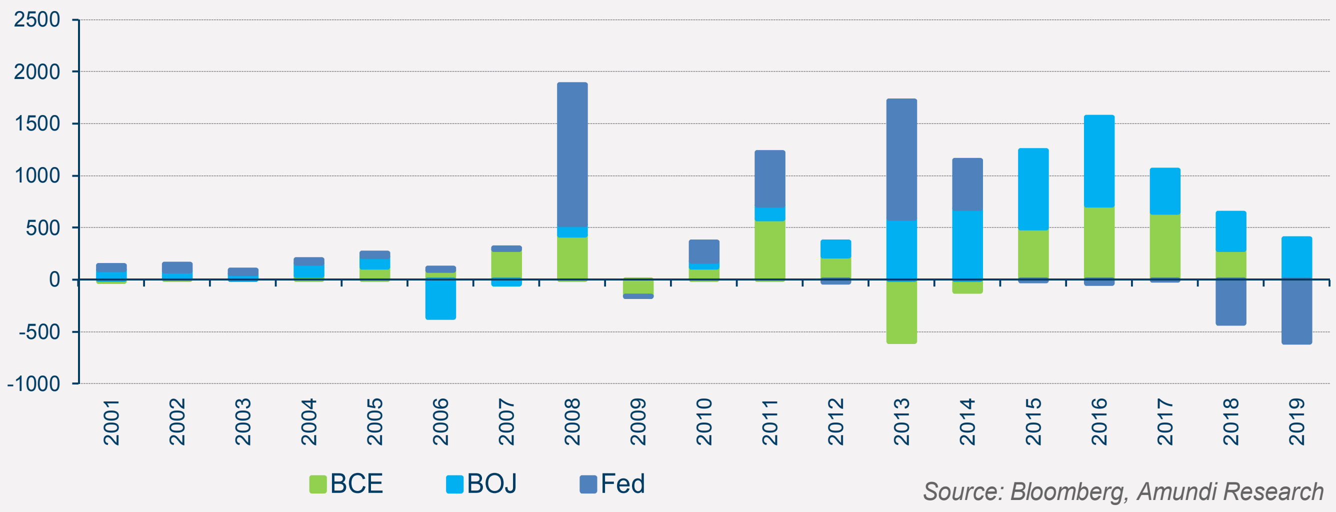
- In the United States, the Fed has begun to gradually reduce the size of its balance sheet by not reinvesting some of the securities that are maturing in addition to the process of increasing rates.
- In the eurozone, we expect the ECB to end its QE in September. The ECB is already buying assets at a rate of €30bn per month, which is half the amount it was in 2017. The ECB has also significantly reduced net purchases of sovereign debt from early 2018.
- In Japan, the balance sheet of the BoJ continues to increase but at a slower pace. In practice, purchases are now in an annual range of 50 trillion yen compared to 80 trillion previously.

The peak of liquidity is behind us. At the global level, net issue volumes of government bonds will no longer be absorbed by CB purchases as in the last three years.

- The combined size of the Fed, ECB and BoJ balance sheets will increase $220bn in 2018 versus $1.1tr in 2017, $1.5tr in 2016 and $1.2tr in 2015.
- According to our calculations, net issuance of long-term US Treasuries could reach $800bn in 2018 and $970bn in 2019 (higher deficits and Fed's non-reinvestments). These amounts are not unprecedented as the net issuance of LT US Treasuries was $1tr in 2012 and as high as $1.6tr in 2010.

"Huge increase in supply of government debt while the Fed is reducing its balance sheet."

4/ **CB balance sheets/Interest rates**



Source: Bloomberg, Amundi Research

The upswing in global growth expectations and the reduction in the accommodative monetary policy stance has already led to an increase in Fed funds expectations, a rise in sovereign bond yields, some outflows on the corporate bond market and a decline in the trade-weighted dollar.

III. Back to a more "normal" market

The "normal" relationship between strong growth, higher inflation expectations and higher interest rates finally seems to have been restored to some extent. This is a new phase of normalisation in fixed-income conditions, where fundamentals will regain their key role. The transition has not been smooth: in less than six months, 10y yields in the US have risen from 2% to 2.9% and the 10y German Bund yield doubled between December 2017 and March 2018.

3.1 US yields: the 10y is fairly priced

Several factors have contributed to the rise in the US 10y yield:

- **Investors have revised their growth forecasts in the US** in particular in 2018 following the adoption in mid-December of the US tax reform. The inflation outlook has also improved, as the tax reform is taking place at a stage when the US economy is already at full employment (US unemployment has been below the longer run unemployment rate – NAIRU – of 4.5% since mid-2017) and is therefore capable of generating gradual upward pressure on wages. Additionally, the scenario on inflation implied by the labour market has been paired with commodity prices trending higher, as oil has managed to break above $60 per barrel since the beginning of 2018. As a consequence, US 10Y breakeven inflation is currently at 2.10% after having tested levels as low as 1.70% throughout 2017.
- **The Fed confirmed its intention to tighten its monetary policy** (growth forecasts revised upward).
- **Markets have also adjusted their expectations on the pattern of Fed funds rates**, moving their projected path for rates from one to three hikes in 2018 over the last six months.

"The cost to hedge dollar investment is very expensive for European and Japanese investors."

We think the markets' main focus going forward is going to be:

- **A potential surprise on inflation**. Our US macro scenario suggests that the US CPI will be on average above 2% over the next two years, peaking at 2.5% in 2018 and fading to 2.2% in 2019. Markets have already broadly priced in a rebound in inflation and history suggests that 10Y break-evens have managed to move materially higher than current levels (getting as high as 2.50%) mostly in times when the CPI consolidates consistently above the 3% mark.
- **Huge amount of net issuance in 2018.**
- The cost to hedge dollar investment that is exhorbitant for European and Japanese investors.

Against this backdrop, on the nominal rates front we expect:

- **the US 2Y to level out at around 2.6% this year** under our current scenario of three hikes by the Fed in total in 2018. However, we remain well aware of the non-negligible risk of a further rate increase from the US Central Bank this year, as mentioned earlier, in which case front end rates would have to sell off further;
- **the US 10Y to keep trading in the 3%-3.15% range towards the end of 2018**, despite our fundamental framework suggesting a fair value above 3%. The increasing concerns of a potential pick-up in trade tensions, uncertainties around the US administration's policy and the market's subdued expectations on the US inflation pattern could continue to work as a ceiling for the yield.
- **the shape of the curve to hold on to the current flattening trend**. Although markets' concerns about an increase in the US fiscal deficit could indeed trigger

temporary episodes of steepening in the US curve, such shifts should fade in the more medium to long term as the Fed continues to tighten monetary policy, as such a mature phase of the economic cycle would suggest.

Finally, in a market environment where we see limited upside for nominal yields and inflation breakevens having repriced higher in the last six months, US 10Y real yields seem to be fairly reflecting the improved growth outlook and are not expected to deviate materially from the 60-80bps range.

Table 1:
Fair Value Drivers

	Dec-18	Dec-19	Dec-20
FED Fund Rate 1yFwd	2.64%	2.91%	3.10%
CPI YOY	2.3%	2.2%	2.3%
Real GDP YOY	3.0%	2.4%	2.3%
PCE Volatility	25%	3.53%	4.19%
CBs Purch. (%GDP)	36%	34%	33%
Foreigners Purch. (%GDP)	6.0%	5.7%	5.4%

Table 2:
Amundi's Fair Values and Targets vs. Forwards

	US 2Y			US 10Y		
	2018	2019	2020	2018	2019	2020
Fwd	2.76%	2.96%	3.09%	3.07%	3.13%	3.19%
Fair Value	2.75%	2.63%	2.85%	3.40%	3.30%	3.60%
Target	2.60%	2.80%	2.85%	3.07%	3.20%	3.30%

3.2 German yields

Several factors contributed to the rise in the German 10y yield between December and March:

- **2017 growth surprised on the upside and the 2018 growth forecast was revised upwards.** Growth in 2017 was supported by a synchronised acceleration in investment spending which boosted global trade and the European industry.
- **The ECB confirmed the gradual reduction in its accommodative monetary policy stance**. The ECB is more confident in the growth outlook. It has substantially upgraded its growth forecast for 2018, from 1.8% to 2.3% (from 1.7% to 1.9% for 2019). The pace of the ECB's QE has been halved to €30bn/month until September 2018 and it is very likely that the ECB will stop its net asset purchases this year.

"The fall in Eurozone inflation poses a challenge for ECB."

The 10y German Bund yield has just declined to 0.5% on the back of protectionist fears and a weaker than expected series of economic data. Most indicators suggest continuing growth but at a slower pace in 2018. Our eurozone economist expects growth in the region to remain above potential for the next two years and inflation to gradually rise. Core CPI should average 1% yoy in 2018, increasing gradually to reach 1.7% in 2020 (below the ECB's target).

We expect the ECB to remain "cautious" and avoid tightening its ultra-loose monetary policy too fast. In its latest minutes, the ECB raised concerns about US trade protectionism and kept a quite cautious stance on inflation.

- We expect the ECB to reduce the sovereign debt programme after September, instead of stopping it suddenly.
- The Central Bank is firmly anchoring market expectations for the first rise in

deposit rates in H2 2019.

- The principal payments from maturing securities purchased under the asset purchase programme will be reinvested for an extended period of time after net asset purchases end.

In that context, we do not expect the eurozone government bond market to be subject to an abrupt sell-off when net purchases reach zero, but to move more closely in line with the macro fundamentals, which a long period of central-bank intervention usually tends to overshadow. Our fundamental framework is currently indicating that the German curve is expensive, both on the 2Y and 10Y segment (as fair values are well above forward yields).

In terms of German nominal yields, Amundi Research expects:

- **the German 2Y to be in the -0.20%/-0.40% range by the end of 2018:** German front end rates are likely to remain anchored to the ECB's forward guidance, therefore not starting to materially pre-empt the first rate hike from the central bank, which is still deemed quite far away into 2019 (currently priced in to materialise in mid-2019).
- **the German 10Y rate to increase to 1%:** although markets have repriced the Bund yield lower in the past couple of months (from 0.75% in February to the current 0.50%), eurozone economic fundamentals are still pointing towards a healthy pace of growth (our fair value model is actually indicating 1.30% as the appropriate level for the Bund rate, according to the macro backdrop), which should underpin a higher level of nominal long-term rates. We see the slowdown seen over the past couple of months on some of the main economic activity indicators and industrial output figures as a limited correction after a long series of positive figures, which should not derail the eurozone from remaining in an expansionary phase and above potential growth throughout 2018.
- If the recent softening were to prove not to be temporary and indicate instead the start of a more persistent weakening phase in the economy, fundamentals would not be supportive to the German 10Y yields to the extent we're currently expecting.
- **The German curve is set to remain under steepening pressure:** according to the above assessment, as long as the ECB is not seen to be close to an increase in interest rates and the macro picture proves resilient and continues to expand. On the European Central Bank front, with the rather dovish recent rhetoric, markets are still focusing on understanding the timing for the end of the PSPP, which is now looking more likely to take place by December than September 2018.

"The German curve is currently expensive both on the 2Y and 10Y segments."

The German 10Y real rate is still in deep negative territory as the adjustment of inflation expectations to higher levels (10Y breakeven is currently standing at 1.35%) has been reflected only to a very limited extent into higher nominals. With nominal yields seen to be increasingly tied to their fundamentals, real rates could move higher into less negative territory, approaching less extreme levels in the area of -0.50bps.

Table 3:
Fair Value Drivers

	Dec-18	Dec-19	Dec-20
CPI YOY	1.77%	1.58%	1.58%
GDP GROWTH (YoY)	2.0%	1.9%	1.9%
RATE 1y3m (%)	-0.37	-0.02	0.20
CPI Volatility	0.32%	0.13%	0.20%
CBs Purchases (% GDP)	36%	34%	33%

Table 4: Amundi's Fair Values and Targets vs. Forwards

	Germany 2Y			Germany 10Y		
	2018	2019	2020	2018	2019	2020
Fwd	-0.36%	0.01%	0.54%	0.77%	0.98%	1.21%
Fair Value	0.00%	0.17%	0.40%	1.32%	1.35%	1.30%
Target	-0.30%	0.20%	0.50%	1.00%	1.20%	1.30%

3.3 On the credit side, limited room for further spread tightening

"Limited room for further spread tightening."

US and European fundamentals have followed diverging trends in recent years:

- Leverage at US companies has reached record levels and is now stabilising or even decreasing in some cases (Energy sector). This trend is likely to improve further on the back of the tax reform. Higher revenues and profits are going to be coupled with a more limited use of debt financing among funding channels.
- Leverage at European companies has remained at low levels. European companies have remained in a cash preservation mode over this cycle.

The technical aspects seem more challenging in the medium term in the US. After years of low funding needs and high investor appetite, the leverage of US companies is near record highs. The refinancing needs of US companies will increase significantly in the coming years. At the same time:

- The growing net supply by the public sector could cause a potential "crowding effect".
- The need to search for yield may become less apparent if Treasury bond yields continue to move north, finally becoming relatively more attractive vs. corporates, and if in the coming years larger oases appear in the deserts of yield in other jurisdictions on the back of normalising monetary policy.

However, there will be no "crowding effect" risk in Europe in the coming years, on the back of a different fiscal policy mix. The search for yield is not yet over in Europe: short to medium segments are still dominated by negative/zero yields. The ECB is concentrating its 2018 QE on corporate purchases, while supply of both corporate and government bonds remain limited.

Both US and European credit markets have delivered fairly positive performances over the past two years: on the back of this rally, it is unsurprising that valuations generally tightened on both sides of the Atlantic. Our fair value models show that valuations are currently rich versus their underlying factors on both sides of the Atlantic and that they have moved into rich territory over recent quarters, sustained by improving macro and micro fundamentals and still quite supportive technicals.

On a relative basis, however, US credit spreads increasingly appeared more stretched than the EUR credit markets for both IG and HY, despite the ECB's direct support for European credit through the CSPP. In a rising yield environment, in particular, US HY spreads look more at the risk of rising than US IG spreads, according to their historical yield ratio-Treasury relationships, which would not be inconsistent with this late phase of the macro cycle. Thanks to the ongoing negative rate environment, European credit is in a better position than its US counterparts in the 1-5-year segment, where the opportunity cost of moving from spread products into risk-free bonds is higher in Europe than in the US.

Default rates

US HY Default rates

Default rate of US HY likely to fall further in the coming quarters, following a steep dive recorded last year

2017 saw default rates of US speculative grade bonds falling sharply, from 5.9% in January to 3.3% in December. The default "mini-cycle" of 2016 and 2017 was not recession or financial crisis-driven but almost entirely led by energy companies, which have seen their default rate drop to 5.6% currently from a 25% peak. This trend within the energy sector should proceed in the coming quarters, lagging by around one year the massive drop in its distress ratio which finally reached historically low levels some quarters ago. As chart 1 shows, the cumulative number of defaulted issuers belonging to all other sectors is still close to the low levels of 2004-2008 and the years following the Lehman crisis.

Looking forward to the next 12 months, our top down model points to a further "landing" of default rates down to a level of 2.6%, from the current 3.3%. The major rationales behind this forecast can be found in macro factors and financial conditions. On the macro side, historical evidence shows that it is not the level of growth but the change in GDP growth with respect to its long-term trend that is the real driver of the default cycle. In this respect and thanks to the likely positive effect of the fiscal reform, our forecasts point to an encouraging outlook for US growth over the coming quarters.

Together with macro growth, the most powerful inputs of our forecasting regressions are currently represented by both trends in financial conditions for bank loans and speculative grade corporate bonds. Both factors lead default rates by around four quarters on average, as the unavailability of credit lines or the sudden closure of the bond market takes some time to produce a "drought" of liquidity and subsequently contribute to an extreme credit event. Both factors are currently pointing to default rates declining to around 2.6% in one year's time. Previous quarters saw improving trends on both indicators: the distress ratio was down to 4.7% from 6.2% by the end of last year, while in terms of bank lending standards, the net percentage of banks declaring easing conditions applied to C&I loans increased to 10% from 8% and 4% in the two previous quarters.

A look at sector trends among bottom up factors is encouraging too as distress ratios are currently mostly negligible or below 10% with the exception of just two sectors, namely the retail sector at 18% and telecoms at 14%. However, these numbers too, are not at levels pointing to a significant rise in defaults. Furthermore, the retail sector represents less than 5% of overall HY debt, much less than the 17% represented by the energy sector at the time of the commodity crisis.

Default rates in the current cycle and the risk scenarios

The current cycle of HY default rates in the aftermath of the Great Financial Crisis continues to be the most benign since 1990, as 2017 marked the fourteenth year of an extremely low period of bankruptcies.

This has certainly to do with an unusual phase of abundant liquidity and search for yield, but it also depends on the low cost at which funding was and still is made available to corporates. In this respect, the current level of US real rates is still a long way from thresholds which proved to be dangerous in the past, coherently with a low growth/low inflation scenario and despite the fact that the Fed is moving down its policy normalisation path.

The outlook looks quite different in the case of a boom and bust scenario, which would record an initial acceleration in growth and inflation, finally urging the Fed to step up its path of policy normalisation and a likely risk of also impacting credit among risky assets. In this case, financial conditions that are currently still easy for speculative grade bonds would suffer from a likely, rapid tightening in both qualitative and quantitative terms, finally leading to a likely upturn in the current default cycle. In this case, the hardest hit issuers would belong to the lowest rated and highly leveraged names.

On the other hand, the extension and expansion of the US business cycle into a sort of pre-GFC regime, marked by a structural return to higher productivity and growth levels led by a rise in investments, would probably show a sort of balancing trade-off between more positive fundamentals on one side and less supportive technicals on the other. In this case, default rates are likely to return to previous (higher growth/ higher yields) patterns but in a gradual way and without the spikes likely in the riskiest boom and bust scenario.

European HY default rates in our central scenario

Default rates in Europe remain at historically low levels and, according to the signals from our top down models, are expected to fall in the coming quarters into the 1.2%-1.5% range. Over the last year the trend proved to be quite stable, as most of the time the rate remained in the 2.0%-2.5% range. Furthermore, thanks to the low exposure to the commodity and oil sectors, European DR even failed to experience the mini-cycle suffered by US speculative grade bonds in 2016 and 2017. The rationales behind these expectations can be found in the improved macro picture and continued accommodative financial conditions, in particular the distress ratio. Moody's projections for the following 12-month period were also steadily and significantly revised down over recent quarters and now also point to the 1% range. Besides direct and indirect support from the ECB, we also underline the steady recovery in bank lending to corporates, which actually picked up in the eurozone in the second half of last year. As a matter of fact, speculative-grade or leveraged loan issuance became stronger especially among B-rated names, which also helped to reduce supply pressure in the HY bond market in early 2018.

Among supportive bottom up factors, we underline the dominant weight of the high-quality BB-rated segment (which accounts for almost three quarters of the overall debt), reducing potential negative impacts from sudden spikes in volatility or risk aversion.

Risk scenarios for European HY defaults

As for US HY, the US boom and bust story would be quite dangerous for European speculative grade defaults, too, especially in terms of negative effects coming from the likely spike in equity implied volatility and the tightening in financial conditions, together with the final "boom effect" on macro growth. At the same time, the ECB finds itself in a much different monetary policy phase from the US, lagging the Fed by at least four years. In order to soften the unwanted impacts on financial conditions from a US boom and bust, therefore, the ECB could find itself in a better position than the Fed in terms of flexibility to calibrate the eventual QE exit on both timing and instruments.

The third case of return to a pre-GFC regime, on the contrary with respect to the previous risk scenario, would give European companies more time to strengthen their fundamentals, especially in terms of earnings cash-flow generation, as the end of the US cycle probably represents the major threat to this picture. Higher structural growth in the US would also support the return of some peripheral countries closer to pre-crisis numbers in terms of GDP growth, ultimately supporting corporates in these countries.

Conclusion

This environment calls for an active approach to fixed income: active in duration management (short with rising rates, but neutral/long when the economic cycle slows down), active in currency management (as CB policies are not fully synchronised), and active in security selection in credit (overall quite tight) to find the right balance between risk and reward. This also calls for enhancing sources of diversification both to hedge against inflation risk (inflation-linked bond) and to capture stronger economic growth (momentum).

NOTES

NOTES

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