Confidence must be earned

Amundi ASSET MANAGEMENT

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Screen the Euro fixed income market in the era of three 'lows'

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Letter to investors

*As 2020 approaches, the **uncertainty** in the market has receded but there are still risks ahead involving macroeconomic, political and technical factors. Under such a scenario and with central banks being accommodative, we do not envisage a major increase in European core bond yields from their current levels given the limited growth potential and the scarcity of tools left in the ECB's toolkit to stimulate the economy. Should the economic situation deteriorate, there could be room for yields to fall, but probably not to the lows reached in late August/early September.*

*Next year the **ECB** will play a crucial role in market liquidity and the financial sector, with its new two-tier banking reserve system and TLTROs boding well for subordinated financial bonds, which are a favoured instrument in the hunt for yield. The central bank will also support credit markets with its recently relaunched purchasing programme. Evidence from the first few weeks of QE2 suggests that the ECB will increase the proportion of corporate bonds in its overall asset purchases, supporting the corporate bond market.*

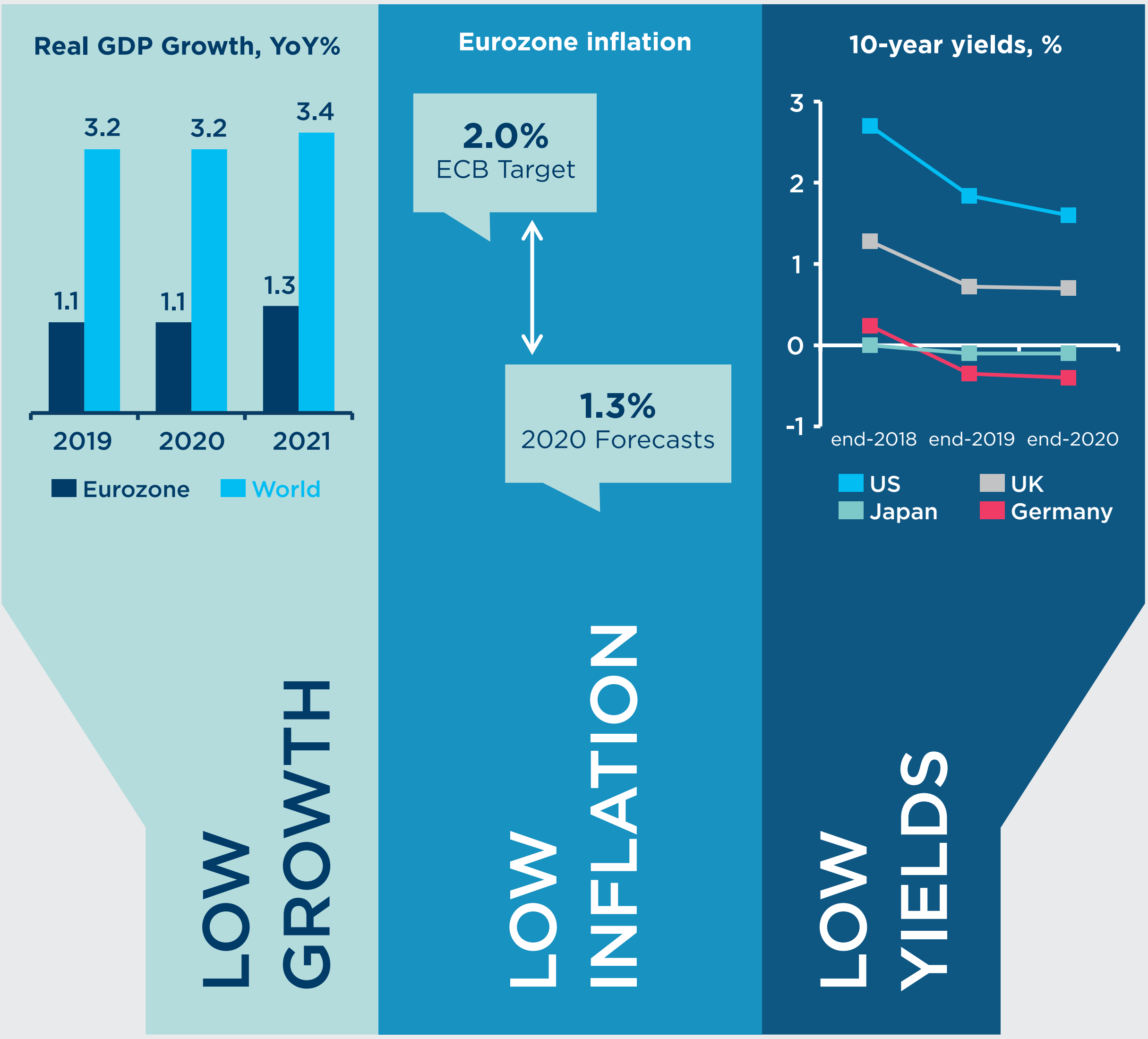
__Regarding our key investment convictions for 2020,__ we believe that alpha will be generated mainly using tactical strategies on duration and curve trends until clearer signals on the market direction allow investors to embrace a more strategic view. Government bond yields are likely to remain stagnant. In a low-growth scenario, investors seeking flattening positions should chase any available premium. Additionally, government bonds from countries that trade at large spreads versus core countries will remain attractive. Inflation-linked bonds are cheap and could be worth pursuing, should headline inflation move higher.

*The prolonged monetary policy easing of the main central banks will support the entire credit spectrum and investors will likely favour **the European segment** in their search for yield rather than other geographies, due to its **better fundamentals and valuations.** In the Euro investment grade space, we prefer bonds that benefit from positive carry. We are positive on the Euro high yield segment, with a focus on cyclical names should trade tensions ease. In the financial space, we favour CoCo and lower Tier II bonds. We are mindful that greater scrutiny is needed on liquidity for the higher yielding sectors in 2020.*

*In any investor's portfolio, Euro fixed income offers diversification and stability under our central 2020 scenario. Investors could play the "core" component of their Euro fixed income portfolio with a focus on **aggregate strategies** that can play duration flexibly, together with yield curves and cross region/sector allocation. Investors could also play a **satellite allocation** to enhance income through high yield and subordinated bonds, as well as a continuum of listed and public debt.*

Eric Brard Gilles Dauphine'

"Subdued growth and inflation and the ECB's accommodative stance are supportive for Euro fixed income."



Definitions

Basis points (bps): One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).

Bond ratings: Source: Moody's and S&P. AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade (high yields). Cash equivalents and some bonds may not be rated.

CoCo bond: A contingent convertible bond is a fixed-income instrument that is convertible into equity if a pre-specified trigger event occurs.

Corporate hybrid: A hybrid security is a single financial security that combines two or more different financial instruments. Hybrid securities generally combine both debt and equity characteristics.

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.

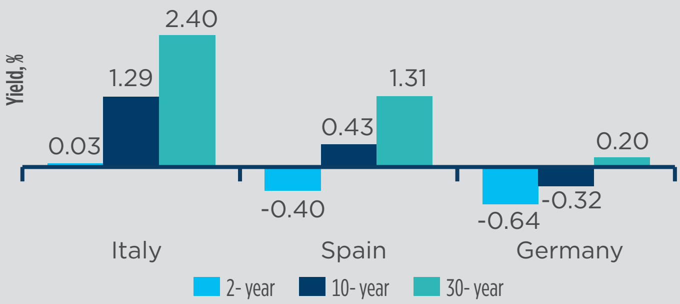
Default rate: % issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofAML indexes. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indexes are from ICE BofA Merrill Lynch.

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.

EURO FIXED INCOME
Opportunities in Euro fixed income

Government bonds: play curve and peripheral

Investors looking at flattening positions should chase any premium. A positive stance on any country's spreads could be attractive in cases in which premiums are available.



Investment grade (IG) credit supported by the ECB

Euro IG Credit is well bid, thanks to strong ECB support, with recent purchases being stronger than in the past and still room to further increase the ECB allocation in this space.

23%
% of corporate bonds in ECB purchases (1-22 November)

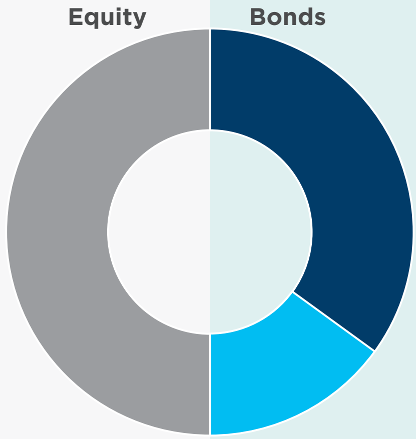
7%
% of corporate bonds in the overall ECB portfolio

High Yield (HY) attractive in the search for yield

Euro HY Credit offers good yield-hunting opportunities, with default rates expected to stay below their long-term average. Selectivity will be key.

Above 3.0%
Euro HY, CoCos, Corporate Hybrids

Rewrite your fixed income allocation for a late-cycle phase with dovish central banks



CORE Allocation

- Aggregate and/or buy and watch, with high-quality assets.
- Focus on alpha generation with duration management and active allocation (yield curve, inflation-linked bonds, peripherals)

INCOME Satellite

- Explore credit opportunities beyond the traditional IG universe (High Yield, subordinated bonds, credit continuum)
- Focus on selection and liquidity management

Source: Bloomberg, Amundi Research. Data as of 4 December 2019.

Date of First Use: 9 December 2019. Devised by: Investment Insights Unit.

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Three 'lows' in Euro fixed income: growth, inflation and rates

Geopolitical risks have receded recently as a *Hard Brexit* has now become less likely and Italy has formed an EU-friendly *coalition government*. In addition, there are prospects for a trade truce between the United States and China. We believe that no new tariffs will be implemented, allowing global trade growth to rebound somewhat from the 2019 lows and then stabilise, albeit at a lower growth pace than in the past. **As a consequence, a global recession has become less likely.** In addition, central banks have shifted to an accommodative stance to support economic growth, with the US Federal Reserve cutting rates three times this year and the ECB restarting its asset purchase programme. **Under such a scenario, growth will remain mostly below potential, especially in advanced economies, inflation will remain below target and government bond yields will be low compared with historical standards.**

"Subdued growth and inflation and the ECB's accommodative stance are benign for Euro fixed income."

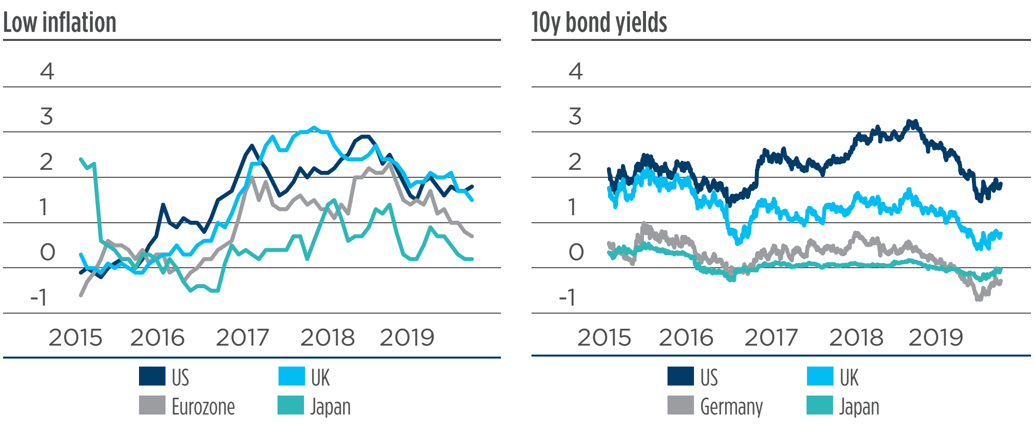
Despite this brighter picture, the risks have not been eliminated completely and markets will still face a few uncertainties in 2020, at both the global and local levels. Such uncertainties include **macroeconomic, political** and **technical factors** that could weigh on financial markets.

On the **macroeconomic front,** the main driving forces for markets in 2020 will be the news on the health of the *Chinese economy* and the run-up to the 2020 US presidential election. Both factors could affect the status of the global bond market throughout 2020 and play key roles in how investors allocate risk.

From a **political standpoint,** the run-up to the presidential election could cause some volatility in the second part of 2020. In Europe, the focus will be on the next developments in the Brexit situation, together with news on the stabilisation of ruling coalition governments in Italy and Spain, particularly in relation to any developments that could lead to early elections in these countries. EU fiscal policy will also be under the spotlight, with some easing expected in 2020. However, significant easing is unlikely, especially in core countries, unless a recession materialises.

Finally, **technicals** will also play a pivotal role in 2020. Following the restart of the ECB's *asset purchase programme* and the introduction of a two-tier system for reserve remunerations, technical factors will be key drivers of market trends in 2020.

Figure 1: Low inflation and 10-year bond yields



Source: Bloomberg, Amundi. Data as of 2 December 2019.

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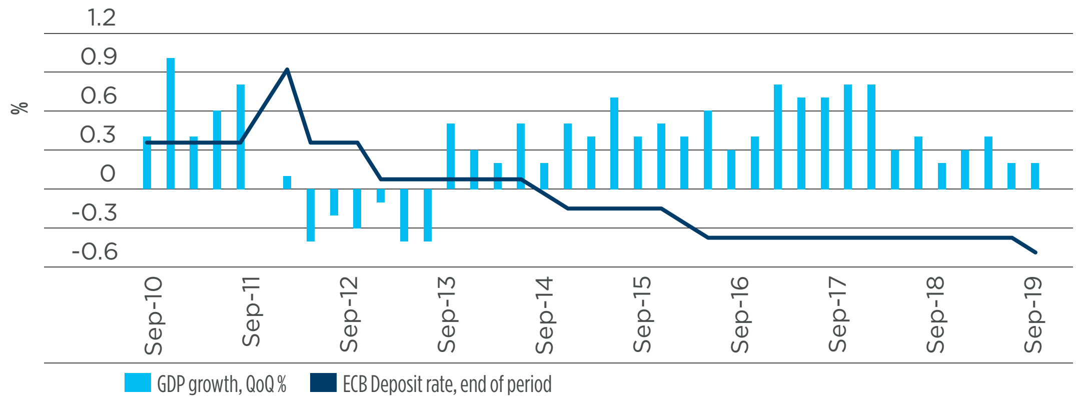
Government bonds: play curve flattening and pheripheral bonds

There has been a significant rebound in core European bond yields since early October and they now appear to be stabilising, thanks to a steadying economy – including Eurozone growth bottoming out and diminishing recession fears – and improving investor sentiment. However, the Eurozone economy remains exposed to the slowdown in global trade and its growth potential looks limited. Also, there is little ammunition left in the ECB's arsenal to stimulate the economy and we believe the central bank does not have much room for manoeuvre. As such, **we do not envisage a significant increase in yields from current levels.** Should the economic situation deteriorate, there could be room for yields to fall, but probably not to the unprecedented lows reached in late August/early September.

Figure 2: Eurozone growth remains weak despite negative rates

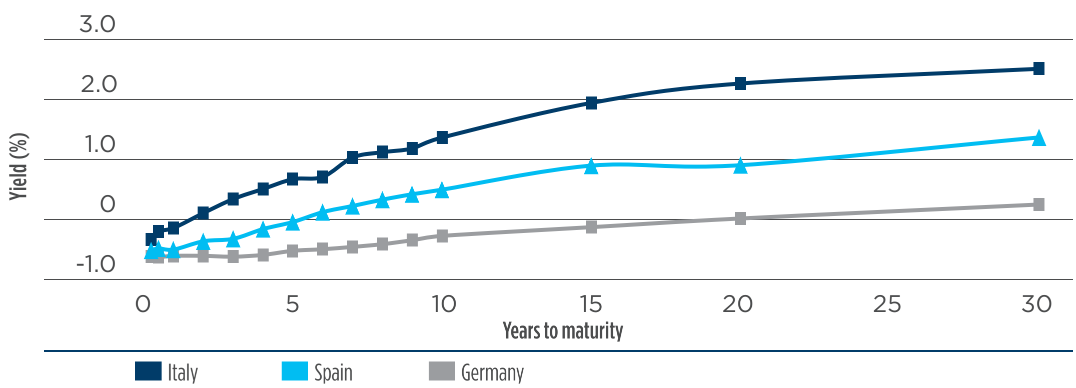


Source: Bloomberg, Amundi. Data as of 5 December 2019.

"Investors looking at flattening positions should chase any premium."

Until the market receives relevant information on the evolution of the economic cycle, **alpha is likely to be generated using tactical strategies on duration and curve trends.** Depending on when clearer signals on the market direction emerge, investors should implement tactical strategies before taking a strategic, longer-term view. Currently, the most likely economic scenario is one of low growth throughout 2020. In such circumstances and with the ECB purchasing programme under way, investors looking at **flattening positions** should chase any premium. Additionally, **a positive stance on any country's spreads** – in either Eurozone countries or non-Eurozone countries issuing euro-denominated bonds – could be attractive in cases in which premiums are available. **Inflation-linked bonds are cheap,** as they currently price in no inflation premium and only reflect the current headline inflation level, which is expected to creep higher over the next few months to catch up with core inflation. **Should the market anticipate that the ECB is on track to achieve its inflation target, inflation-linked bonds could outperform significantly.**

Figure 3: Opportunities from curve flattening and peripheral bonds



Source: Bloomberg, Amundi. Data as of 2 December 2019.

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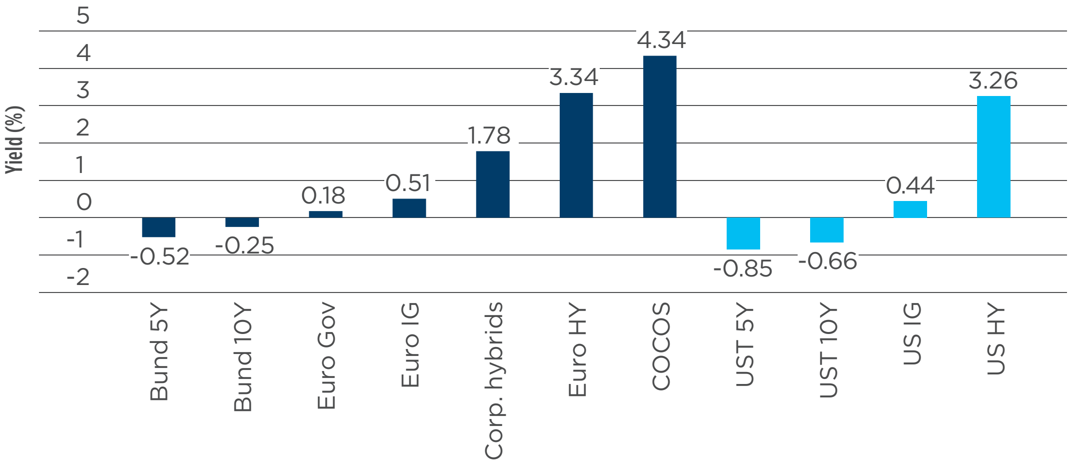
"At the sector level, investors should favour CoCo and lower Tier II bonds in the financials space."

Investment-grade credit is well bid, thanks to strong ECB support

In a low-yielding environment, investors have favoured the limited positive-yielding segments of the Eurozone bond market. They have invested in bonds yielding appealing spreads over government bonds, e.g., bonds with high betas or longer-dated bonds (with maturities above 10 years) at the expense of shorter-dated securities.

In the **Euro IG space,** we favour bonds that benefit from positive carry, currently at around 50 bps for the Euro Corporate Index. At the sector level, investors should favour **CoCo and lower Tier II bonds** in the financials space, with a preference for sectors such as **telecom, energy, real estate and utilities. Selectivity will be a top priority for investors in 2020,** as dispersion is high and picking the right names will be crucial.

Figure 4: Yield-to-worst across the fixed Income universe (euro hedged)



Source: Bloomberg, Amundi. Data as of 15 November 2019.

The main driver for the credit market will be the new ECB corporate sector purchase programme (CSPP). The ECB's QE2 programme has started on a strong footing and with a tilt towards the private sector. In the first three weeks of November the ECB bought €20.2bn of bonds, higher than the announced monthly pace of €20bn.

Table 1: Breakdown of ECB purchases (1-22 November)

	Government Bonds	Corporate Bonds	Covered Bonds	ABS
Amount € bln	12.5	4.6	2.5	0.6
% of the total	62%	23%	12%	3%

Source: Bloomberg, Amundi. Data as of 29 November 2019.

The private sector has accounted for 38% of the ECB's purchases thus far, a higher share than in the first programme. Currently at 23%, corporate bond purchases have picked up, as their share of the overall APP previously ranged between 10% and 20%. We believe this trend will continue and the **share of corporate bonds on overall asset purchases will be higher than in the first QE round** due to multiple factors.

Firstly, the ECB's current holdings of corporate bonds account for only 20% of the eligible universe compared with 39% of supranational bonds and 25% of sovereign bonds. In addition, the eligible universe has expanded in 2019 from about €840bn to €910bn currently, thanks to strong new issuance.

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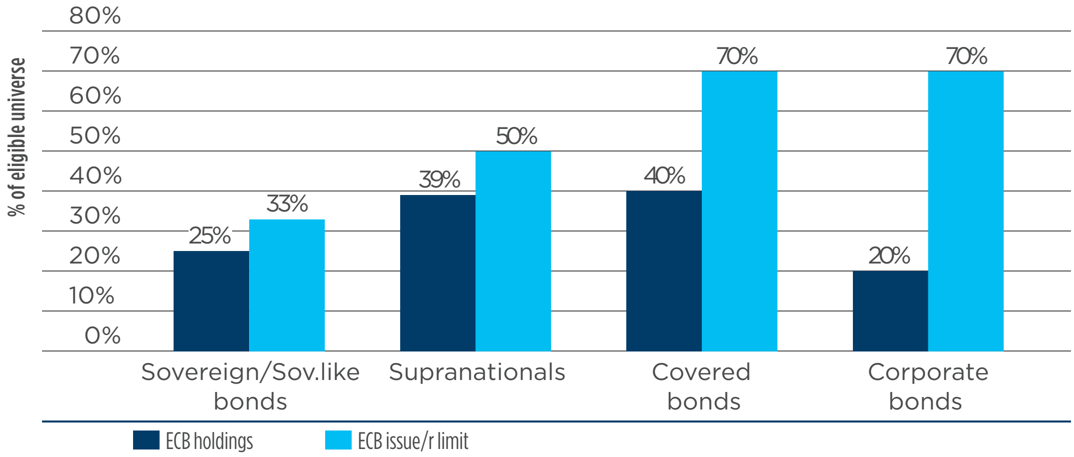
Figure 5: Estimated ECB holdings, % of eligible universe vs regulation limits

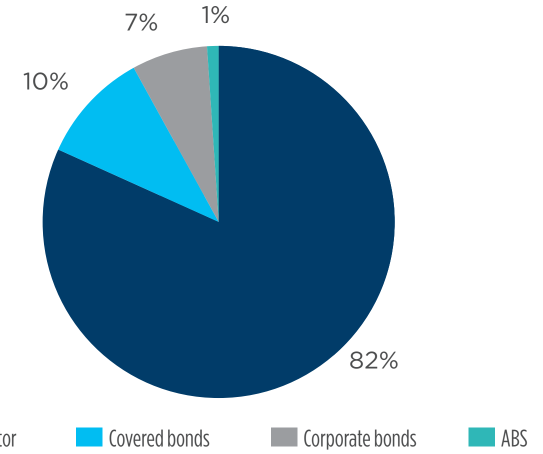


Source: Bloomberg, Amundi Research. Data as of 12 November 2019.

"The ECB held only 20% of the eligible corporate bonds at the end of its first QE round, the lowest share among its purchasing programmes."

The space available on private programmes will allow the ECB to concentrate its purchases on these market segments and alleviate the scarcity issue of a few sovereign bond markets (we estimate the ECB's holdings of German debt as being close to 30%). A tilt towards the private sector will allow the QE2 programme to run for longer, with no amendments needed to the issue/issuer limits on the public sector purchase programme (PSPP). **Finally, corporate bonds currently account for only 7% of overall ECB holdings, so there is room to increase such holdings while keeping credit risk under control.**

Figure 6: Share of ECB holdings in the overall APP portfolio



Source: Bloomberg, Amundi Research. Data as of 12 November 2019.

"Corporate bonds account for only 7% of the overall ECB portfolio, so there is room to increase their holdings while keeping credit risk under control."

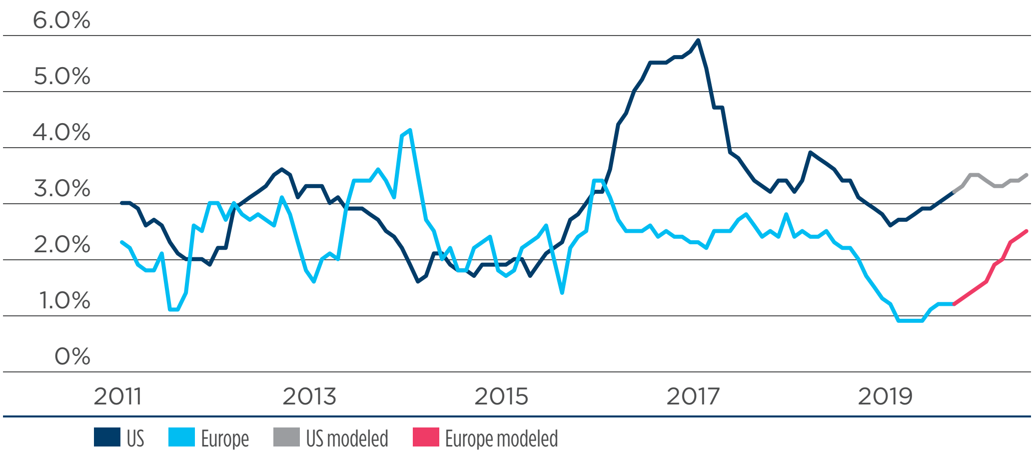
All of the above observations bode well for corporate bonds' technical factors and this market should stay well supported into next year. However, we should bear in mind that it is still early days in the new QE2 programme and that some frontloading in purchases usually occurs before the holiday season. Therefore, evidence from the first few weeks of purchases may not match with the overall investments of the programme.

APP reinvestments will also support market trends in 2020. Forthcoming redemptions within the PSPP announced by the ECB point to an estimated increase of around €40bn in 2020 compared with 2019. In relation to the CSPP reinvestments, we estimate that these will rise significantly, from an average €400m per month in 2019 to an average of €1.2bn in 2020. CSPP reinvestments will total an estimated €16-18bn in 2020 as a whole, compared with just €6bn in 2019 and €4bn in 2018.

HY credit is attractive in the search for yield, with a focus on avoiding idiosyncratic risks

Yield-hunting opportunities may also be offered by the **European HY market.** This market has been bearing the brunt of slow economic and earnings growth but the accommodative monetary policy stance will temper the deterioration in leverage and coverage ratios. Default rates are likely to rise from the current low levels, but remain below their long-term average. Highly rated names will show a limited rise in financial leverage on average, so selectivity will be key in navigating the Euro HY market next year to avoid idiosyncratic risks.

Figure 7: HY default rates: a mild pick-up but still under control



Source: Bloomberg, Moody's, Amundi Research. Data as of 17 October 2019.

"A trade truce between the US and China could favour cyclical sectors in 2020."

At the sector level, mining, paper and automotive have been under pressure this year due to the rising uncertainty, specifically the US-China trade dispute. A trade truce between the two countries could favour cyclical sectors in 2020, including automotive and cyclical services. In any sector, selection will be a top priority in 2020 to avoid the idiosyncratic risks that can impact performance significantly. Specific stories to be avoided include highly leveraged companies in sectors that face both cyclical and structural issues, such as technological changes. Their high level of debt may not leave them enough flexibility to adapt.

Francesca PANELLI
Amundi Investment Insights Unit Specialist

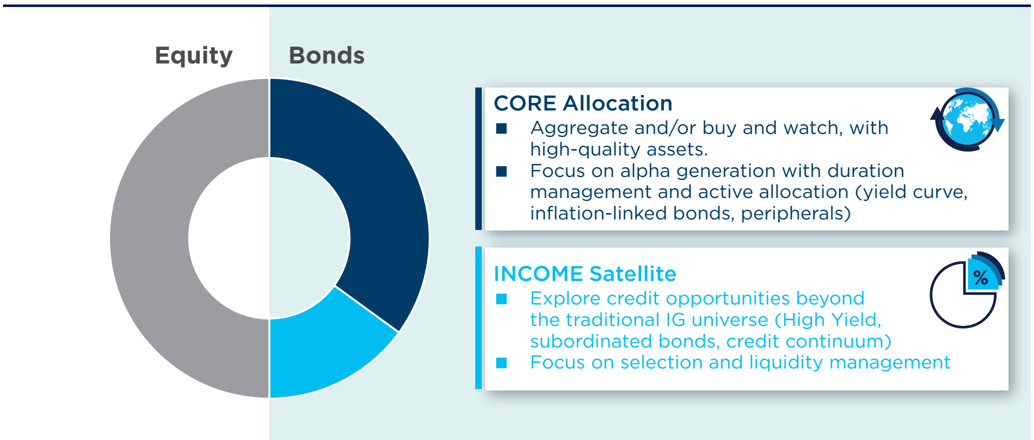
How to play Euro fixed income opportunities

In the ocean of uncertainties described above, Euro fixed income represents an island of relative stability. Factors to focus on include **growth levels** that are neither too hot nor too weak, **credit fundamentals** that are not overextended (with relatively low funding costs) and **technicals** that should bring some price stability to the market (the ECB's CSPP and two-tier reserve remuneration scheme), as well as the **attractiveness of the asset class** for overseas investors, notably Asian investors. Combining these elements, Euro fixed income offers both diversification and stability in what is likely to be a more volatile environment.

Investors should focus on building a **core bond allocation** with a robust process to select the best high-quality and liquid assets. In addition numerous market technicals (many of them generated by ECB's policy) offer room to supplement the core allocation with a set of **relative-value strategies**. As to optimise **income generation** investors might complete their allocation with a selection of assets providing higher expected returns, such as **high-yield bonds, subordinated bonds or continuum portfolios** with a mix of bonds, loans and securitised assets.

"Investors should focus on building a core bond allocation of diversified high-quality and liquid assets."

Figure 8: Portfolio construction for a late-cycle phase with dovish central banks in action



Source: Amundi, as of 27 November 2019. For illustrative purposes only.

In the hunt for yield, a favourite for next year is the **financial subordinated bond market.** Subordinated financial bonds show better valuations compared to both senior financial bonds and non-financial bonds, the latter being eligible for the ECB's CSPP. The European banking sector has progressed noticeably in terms of capitalisation and reduction in non-performing loans. In 2020 it will benefit from recent ECB measures including TLTROs and the two-tier reserve remuneration scheme. As such, the **subordinated bond market offers yield opportunities**. An in-depth credit research would help to add value by detecting idiosyncratic risks in this space. **ESG factors** are also increasingly relevant in the selection process and they should become mainstream in fixed income investing.

"Asset managers should adapt their investment style to suit the client's liquidity needs, whether it is via an active, model-driven or 'buy-and-hold' type approach."

A key focus for investors in 2020 will be market liquidity. This is crucial in facilitating normal operations and asset price movements in financial markets, as highlighted in our recent *piece Liquidity dilemma needs a regulatory response*. Assessing liquidity conditions is an intrinsic part of building and managing fixed income portfolios and should be an inherent part of the investment philosophy of any fixed income investor. To assess liquidity conditions, it is vital to regularly monitor trading data. More specifically, fixed income investors should consider the client's liquidity requirements. Therefore, asset managers should adapt their investment style to suit the client's liquidity needs, whether via an active, model-driven or 'buy-and-hold' type approach. A **continuum of investment solutions** with different income/ liquidity profiles can help investors choosing the best fit for their investment needs and liquidity requirements

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.
- **Carry:** The carry of an asset is the return obtained from holding it.
- **CoCo bond:** A contingent convertible bond is a fixed-income instrument that is convertible into equity if a pre-specified trigger event occurs.
- **Corporate hybrid:** A hybrid security is a single financial security that combines two or more different financial instruments. Hybrid securities generally combine both debt and equity characteristics.
- **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.
- **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.
- **Lower Tier II:** This is the secondary component of a bank's capital that makes up a bank's required reserves. Tier II capital is composed of items such as revaluation reserves, undisclosed reserves, hybrid instruments and subordinated debt.
- **Frontloading:** Issuing as many bonds as possible at the start of the year, when there is ample liquidity in the market.
- **PSPP:** Public sector purchase programme.
- **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.
- **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.

AMUNDI Investment Insights Unit

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