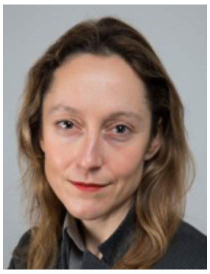
THIS MONTH'S TOPIC

Fixed-income markets: from cyclical to structural challenges



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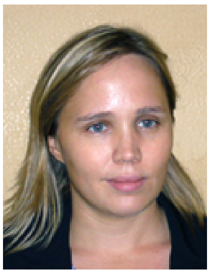

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Since the start of the year, bond yields have surged in the economies of the G10 as markets anticipate a sharp acceleration in inflation and economic activity. This rebound is likely to be particularly strong in the US given its enormous fiscal stimulus plan. In the medium term, opinion is divided concerning the post-Covid crisis macroeconomic trajectory and a possible change in the inflation regime in the US.

During the last quarter, US 10-year yields reached the milestone rate of 1.6%, dragging in their wake German 10-year rates, which rose by 22bp to -0.35%. These figures reflect greater investor confidence in the growth outlook for the US economy. Given the extent of the fiscal stimulus programme, we now expect growth in the US to reach nearly 8% in 2021 and 4% in 2022, with inflationary pressure remaining contained. The situation is different in the Eurozone, which should take longer to return to pre-Covid growth trends. Ultimately, the rise in bond yields does not put the same pressure on the Fed and the ECB.

The Fed will support economic recovery in the US by tolerating higher inflation

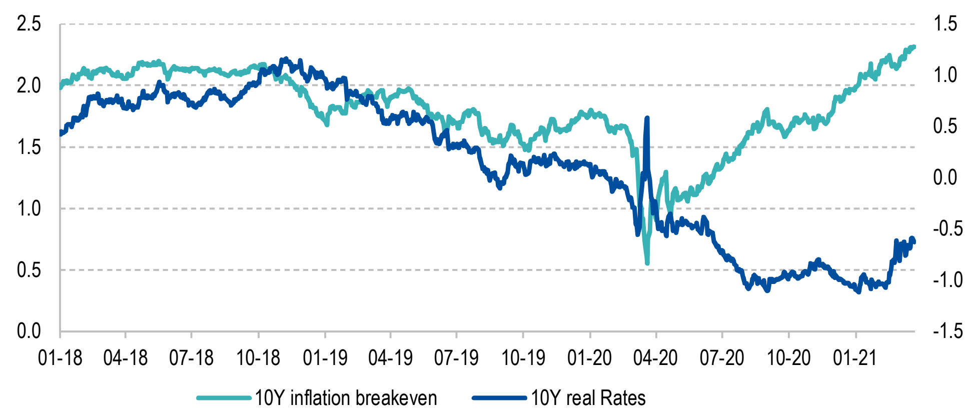
The members of the Fed were not unduly concerned about the recent rise in yields. Long-term real yields, which were at excessively depressed levels at the end of the year have returned to more normal levels, while the long-term inflation breakevens are approaching levels more consistent with a Fed successful in achieving its symmetric 2% inflation target. In J. Powell's latest speech, he gave no indication that the Fed would seek to contain this recent rise in yields. On the contrary, the Fed embraced the notion of rising yields because of an improvement in the growth outlook. Important point: financial conditions remain very accommodative.

At the same time, the Fed will not act pre-emptively: J. Powell said they would not act pre-emptively based on forecasts but would rather wait to see actual data, and that it would take people time to adjust to that new practice. J. Powell therefore kept a prudent tone and recommended patience concerning any change in monetary policy. He said it would take some time for substantial progress to be seen and that it would also take some time for unemployment to go down. Nevertheless, a notable change was evident in the Fed Chairman's discourse: J. Powell clarified that an increase in rates would be possible under certain conditions: (1) maximum employment, (2) inflation reaching and staying at 2%, and (3) inflation increasing moderately above 2% for a certain length of time. This differs significantly from the previous message that they envisaged no rate hike.

The FOMC expects no fed funds rate hike before 2024 (median projections) despite the upward revision to economic growth, employment and inflation projections. Unemployment and the core PCE are expected at 3.5% and 2.1% respectively in 2023. The members of the FOMC stressed that uncertainty was still very high around the virus but also highlighted the nature of the recovery and the extent of fiscal support. The Fed does not fear an overheating: inflation should remain slightly above 2% over the coming years (core PCE at 2.2% in 2020, 2.0% in 2021 and 2.1% in 2022). In this context, only 7 of the 18 members of the FOMC expect a rate hike before 2024 (4 in 2022 and 3 in 2023).

The Fed is now officially behind the curve

1/ **The upward move in nominal yields has been driven recently by an increase in real yields**



Source: Bloomberg, Amundi Research, Data as 22 March 2021

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The Fed believed that a rise in inflation would be neither particularly large nor persistent

The ECB is preoccupied by the recent rise in yields

The members of the Governing Council remain prudent given the recent rise in bond yields. The ECB has clearly stated a preference for keeping low levels of nominal/ real yields and relatively flat curves.

- Christine Lagarde said that the ECB was closely monitoring the evolution of longer-term yields.
- Isabelle Schnabel added that "a too abrupt increase in real interest rates on the back of improving global growth prospects could jeopardise the economic recovery".
- Fabio Panetta pointed out that we are already witnessing unwelcome contagion from the rise in US yields which is incompatible with the outlook and negative for the recovery.

In fact, the European economy will take longer than the US economy to return to its pre-Covid growth trends. The economic gap between the United States and the Eurozone is expected to widen: (1) the United States entered the Covid crisis with a much stronger economy (2) the pandemic has more strongly affected the euro zone (3) fiscal support is much stronger in the United States.

Also, the Covid crisis has increased economic fragmentation within the Eurozone. Germany, Austria and the Netherlands have seen a less severe recession: more ambitious emergency and recovery plan, reduction in restrictions and less exposure to the tourism sector. Italy, Spain and France have been particularly badly hit by the crisis.

As long as economic fragmentation prevails in the Eurozone, the ECB must maintain a stable cost of financing of public debt. Fiscal policy can only be effective if sovereign yields remain low and stable even in the face of growing deficits. In the absence of a significant rise in growth expectations, the ECB stands alone in trying to avoid financial fragmentation. The ECB's capacity to convince the market through its communication and action of its ability to control interest rates will be decisive for peripheral yields and credit spreads. After the acceleration in the pace of purchases under its emergency program, we expect the ECB to increase the size of the programme.

The upward pressure on bond yields led by US treasuries remains therefore a threat for the Eurozone. The ECB will have to manage the economic divergence between the US and the Eurozone over the coming months. Moreover, If there is any change in the inflation regime in the US, it would pose a real challenge for the European Central Bank and the Eurozone economy.

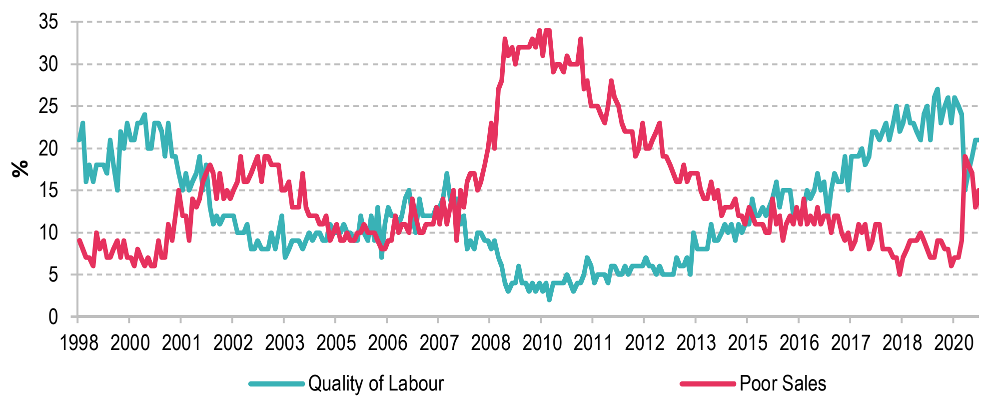
Will we emerge from the Covid crisis with a fundamentally different macroeconomic trajectory from that which we were in at the start of the crisis?

We do not think that the pent-up demand from the pandemic and the $1.9tr government stimulus will reverse the forces that have driven interest rates down over the last decade. Moreover, US reflation trade cannot go too far too fast. High asset prices and high debt levels make growth fragile. The recovery is conditional on stable asset prices (real estate, corporate debt, equity). There is much more sensitivity to underlying movements in rates.

However, a new trajectory of inflation is possible because structural changes can be put in place.

1. **The Fed is willing to let the economy run hot.** The section of the economy not directly affected by Covid performed well during the crisis. Thanks to the Fed, the cost of corporate debt has fallen massively. Well-capitalised companies benefit from an incredibly low level of interest rates for their development:

2/ **Difficulties in finding qualified workers is not far from pre-crisis levels**



Source: Bloomberg, NFIB survey, Amundi Research, Data as of 28 February 2021

THIS MONTH'S TOPIC

The ingredients are in place to see a structural change in the inflation regime in the United States

M&A activity remains very strong, driven by the consumer non-cyclical, tech and communication sectors. Highly leveraged companies also have the opportunity to significantly reduce the cost of their debt. Indeed, activity on the HY primary market for refinancing purposes is very strong. Consequently, on the labour market the context is very different from 2008. Small businesses are struggling to hire qualified workers, despite high unemployment.

2. **The Biden administration is committed to increasing potential growth through an infrastructure plan and a reduction of social inequalities.** Wage growth in the last decade has been uneven, with notable growth only at the top while wages for most workers have failed to rise. Moreover, this crisis has raised social inequalities to barely sustainable levels, mainly affecting low-paid and low-skilled workers. Today, 40% of the jobless population are long-term unemployed.
3. **The cost of supply is rising.** Raw material inflation has picked up, mostly for Covid reasons. However, the long-term supply cost could also be on the rise (significant raw material needs due to infrastructure plans, relocation, environmental costs). In this context, it is time to pay attention to pricing power within sectors.

The already sharp repricing in long-term global yields will continue driven by a strong acceleration in the global recovery over the next quarters. The rise in yields will be driven by breakevens and real rates, which both retain upside potential as the recovery progresses. Thanks to continued support from the ECB, we expect a very modest rise in German bund yields and we are maintaining our positive positions on peripherals. **We expect 10Y UST-Bund spreads to continue to widen. We need to closely monitor the risk of rising inflation in the United States**.

Finalised on 24 March 2021

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April 2021 #04

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