Confidence must be earned

Amundi ASSET MANAGEMENT

H1 2020

Fixed income: Back to core – Charts and Views

Build a robust 'core' and diversify income sources

Investment Insights | Market Stories

Fixed income: Back to core
Search for income, be flexible, and mitigate liquidity risk

Eric Brard
Head of Fixed Income

Dear client,

The ongoing slowdown in global trade will weaken global GDP growth further in 2020 – especially in advanced economies skewed towards the manufacturing sector – but a full-blown recession is unlikely, in our view. This situation will encourage policymakers to finally add fiscal stimulus to the policy mix, possibly extending the economic and credit cycles. Monetary policy is unlikely to become much more accommodative and market expectations will have to adjust, likely driving bond volatility higher with a possible bottoming out of core bond yields.

In this environment, fixed income investors should, ***firstly, build*** *allocation to exploit opportunities wherever available and get the most out of Euro and* ***a robust 'core'*** *global aggregate bond markets. A flexible and well diversified approach is best suited to dealing with possible diverging scenarios that will become clearer in the coming months.*

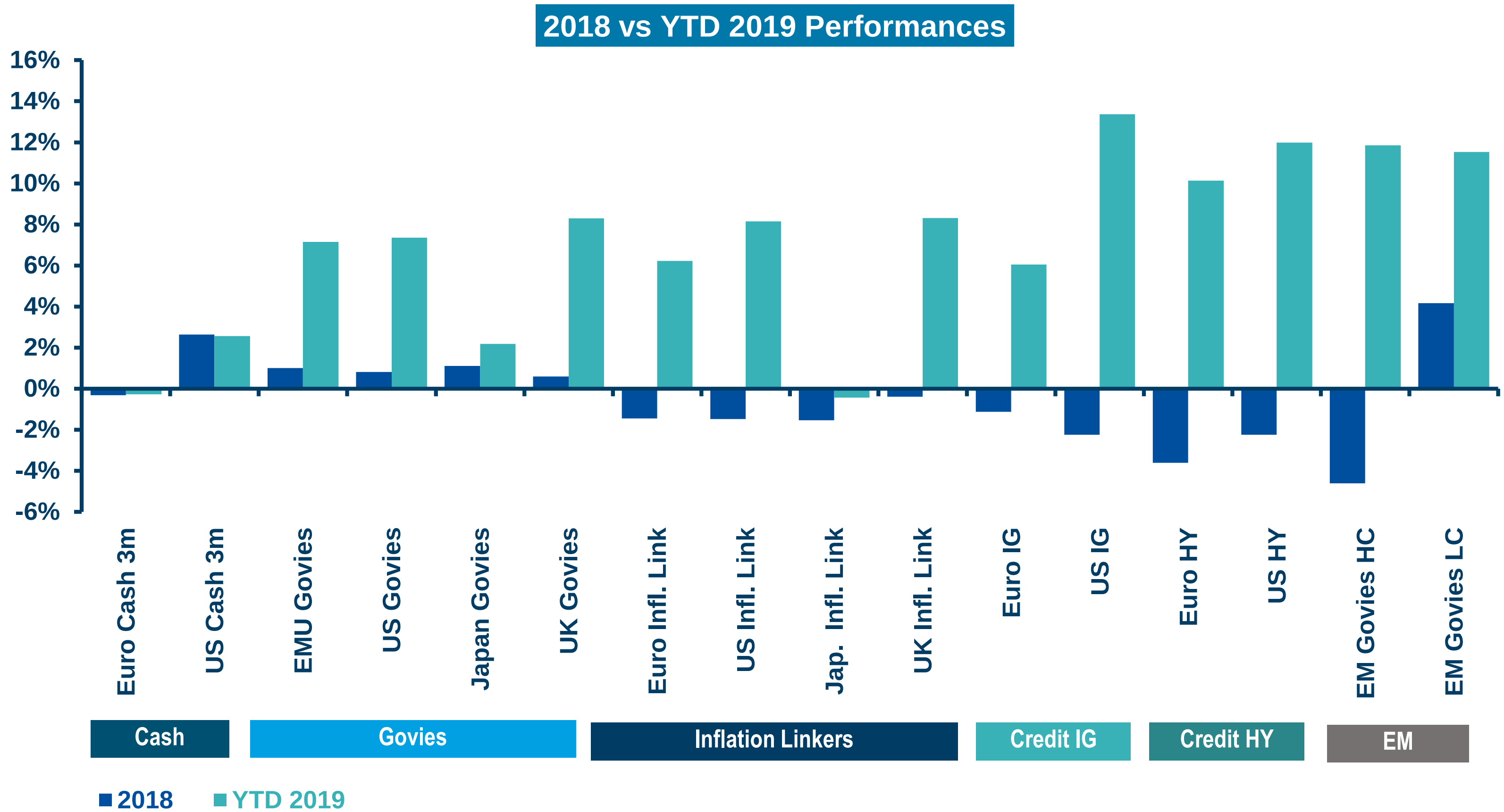
Secondly*, as core bond yields should stay low, the search for income will remain a key theme, but will require deeper scrutiny of markets.* ***Investors should seek to put in place dedicated exposures to higher-yielding segments*** *(HY bonds, subordinated financial bonds, a continuum between private and listed debt). In a late-cycle environment, a strong focus on selection and liquidity management will be key to protecting investors in case of deterioration of economic conditions and rising idiosyncratic risks.*

This publication combines views from our global teams of portfolio managers, economists, strategists and Investment Insights specialists with the aim of providing our ideas for investing in fixed income markets over the next few months.

We hope you find it helpful.

Eric Brard

Robust performances by fixed income markets in 2019



Source: Bloomberg, Amundi. Data as of 3 December 2019. All indexes are total return in local currency. For the list of indices used in this chart, see notes at the end of the presentation. **Past performance is no guarantee of future results.**

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Short-term relief, but challenges remain in medium term

KEY THEMES

DECENT GLOBAL GROWTH, BUT WEAKER THAN EXPECTED

Global growth remains decent, but weaker than expected and vulnerable. There are signs of stabilisation for H1, but fragilities will persist in a late cycle.

CENTRAL BANKS IN EASING MODE, FISCAL SUPPORT IS NEEDED

CBs have acknowledged that growth is vulnerable and remain accommodative. Focus on fiscal measures to stimulate the economy; some emerging countries are already relaxing fiscal policy.

DOMINANCE OF POLITICS

Geopolitical risks have eased in the short term: a hard Brexit should be averted and a partial trade deal is in sight. However, the dominance of politics will resurface next year, with the US election, trade noise, and some idiosyncratic stories in the Middle East and Latam.

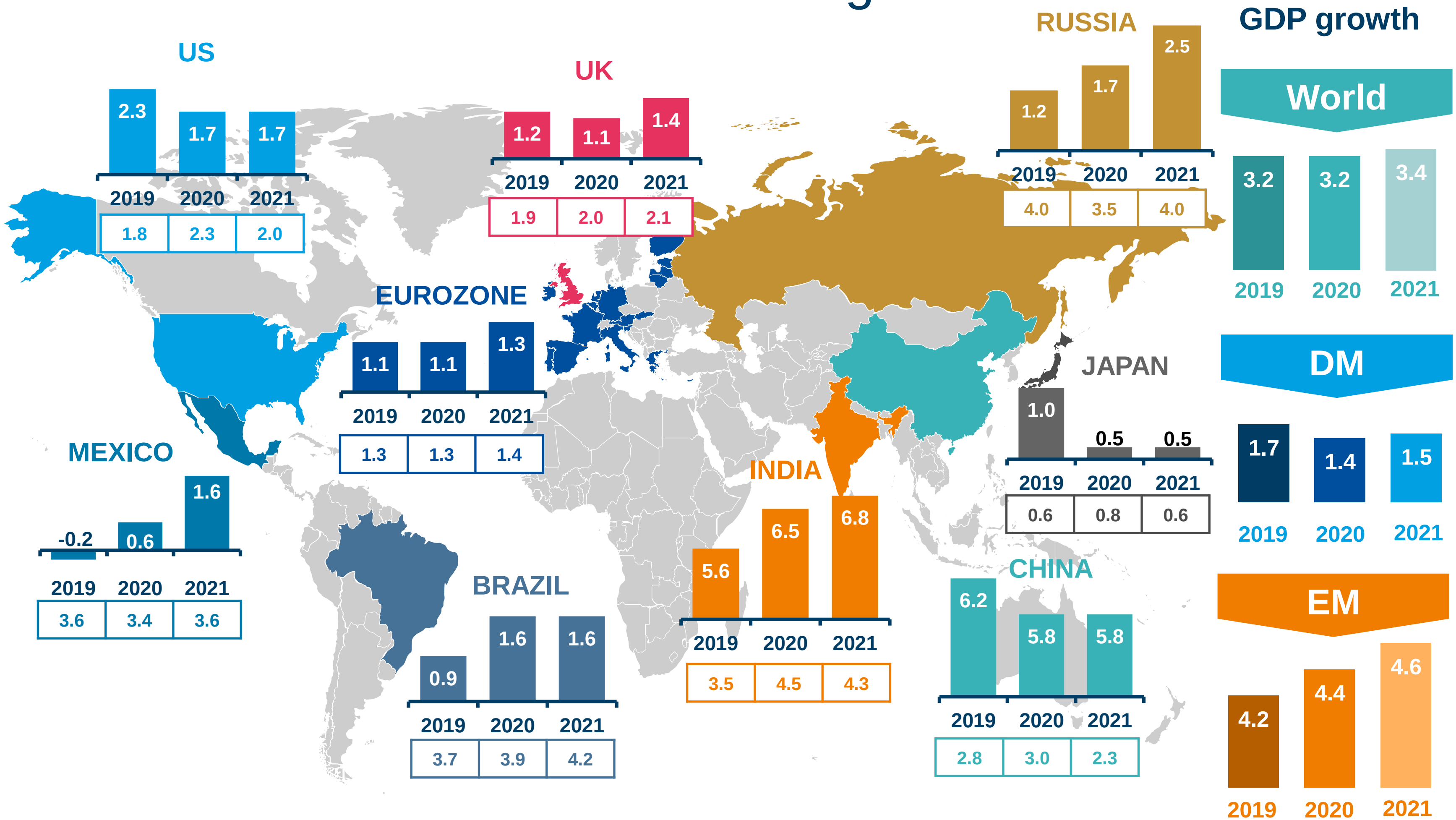
LONG-TERM FOCUS

GLOBAL RISKS, WITH A FOCUS ON CLIMATE CHANGE

Long-term challenges include: global trade retreat and protectionism, high/growing debt, climate change, and central banks' independence under threat.

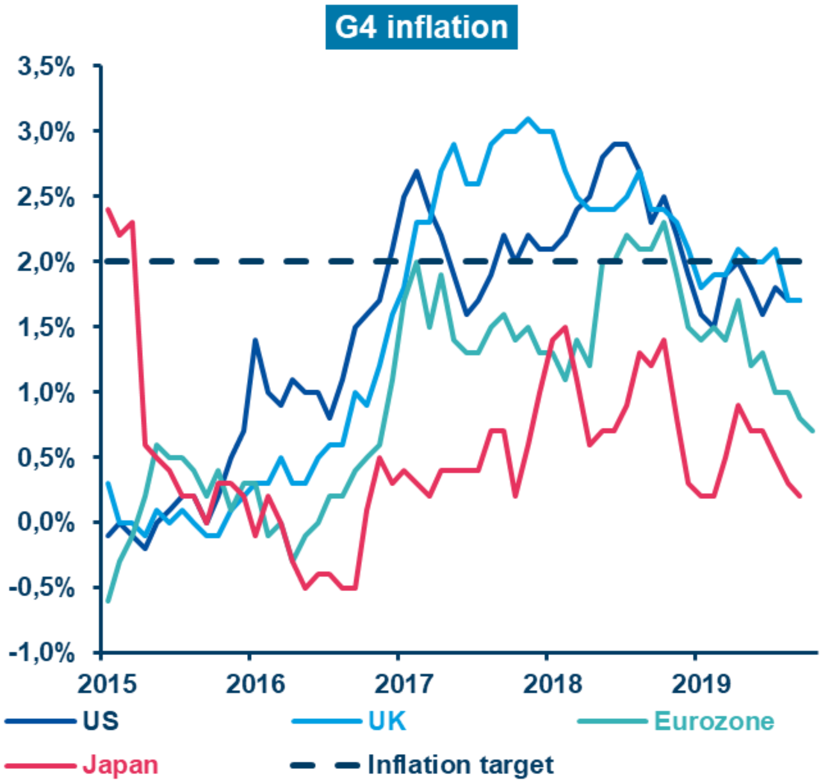
Source: Amundi as of 30 November 2019.

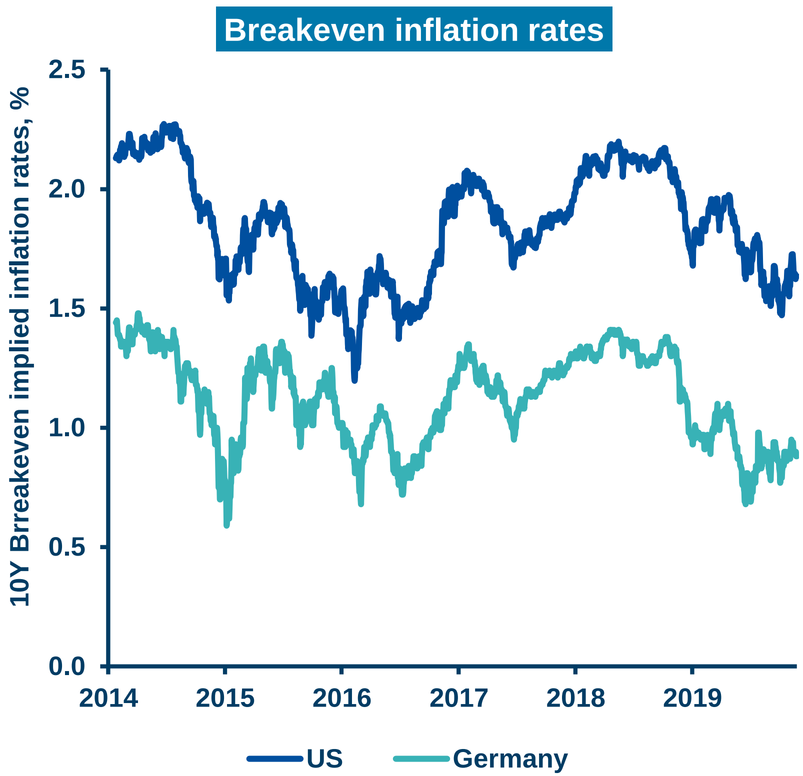
Growth outlook: stabilisation in sight



Source: Amundi Research; Latest forecasts are as of 30 November 2019. Data in percentages. Bars represent real GDP growth (YoY %) forecasts, tables show inflation (CPI, YoY %) forecasts.

Inflation still subdued in developed markets



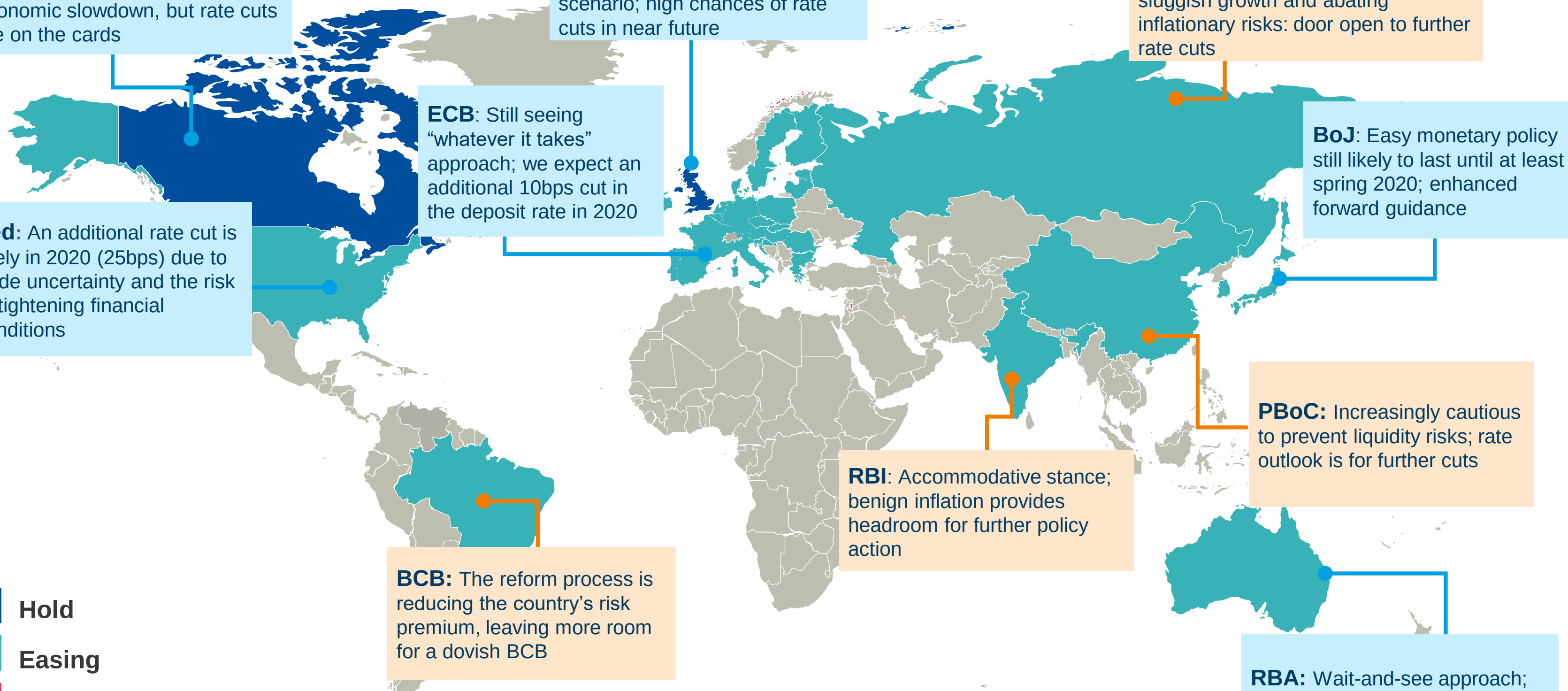


» Inflation rates should mostly be below target in 2020, as discounted by bond markets, with major developed economies expected to grow below potential.

Source: Bloomberg, Amundi. Data as of 25 November 2019.

Source: Bloomberg, Amundi. Data as of 25 November 2019.

Central banks remain accommodative



BoC: On hold despite global economic slowdown, but rate cuts are on the cards

BoE: Policy depends on Brexit scenario; high chances of rate cuts in near future

CBR: Monetary easing amid sluggish growth and abating inflationary risks: door open to further rate cuts

ECB: Still seeing “whatever it takes” approach; we expect an additional 10bps cut in the deposit rate in 2020

BoJ: Easy monetary policy still likely to last until at least spring 2020; enhanced forward guidance

Fed: An additional rate cut is likely in 2020 (25bps) due to trade uncertainty and the risk of tightening financial conditions

PBoC: Increasingly cautious to prevent liquidity risks; rate outlook is for further cuts

RBI: Accommodative stance; benign inflation provides headroom for further policy action

BCB: The reform process is reducing the country’s risk premium, leaving more room for a dovish BCB

RBA: Wait-and-see approach; possibility of greater focus on fiscal policy

Hold

Easing

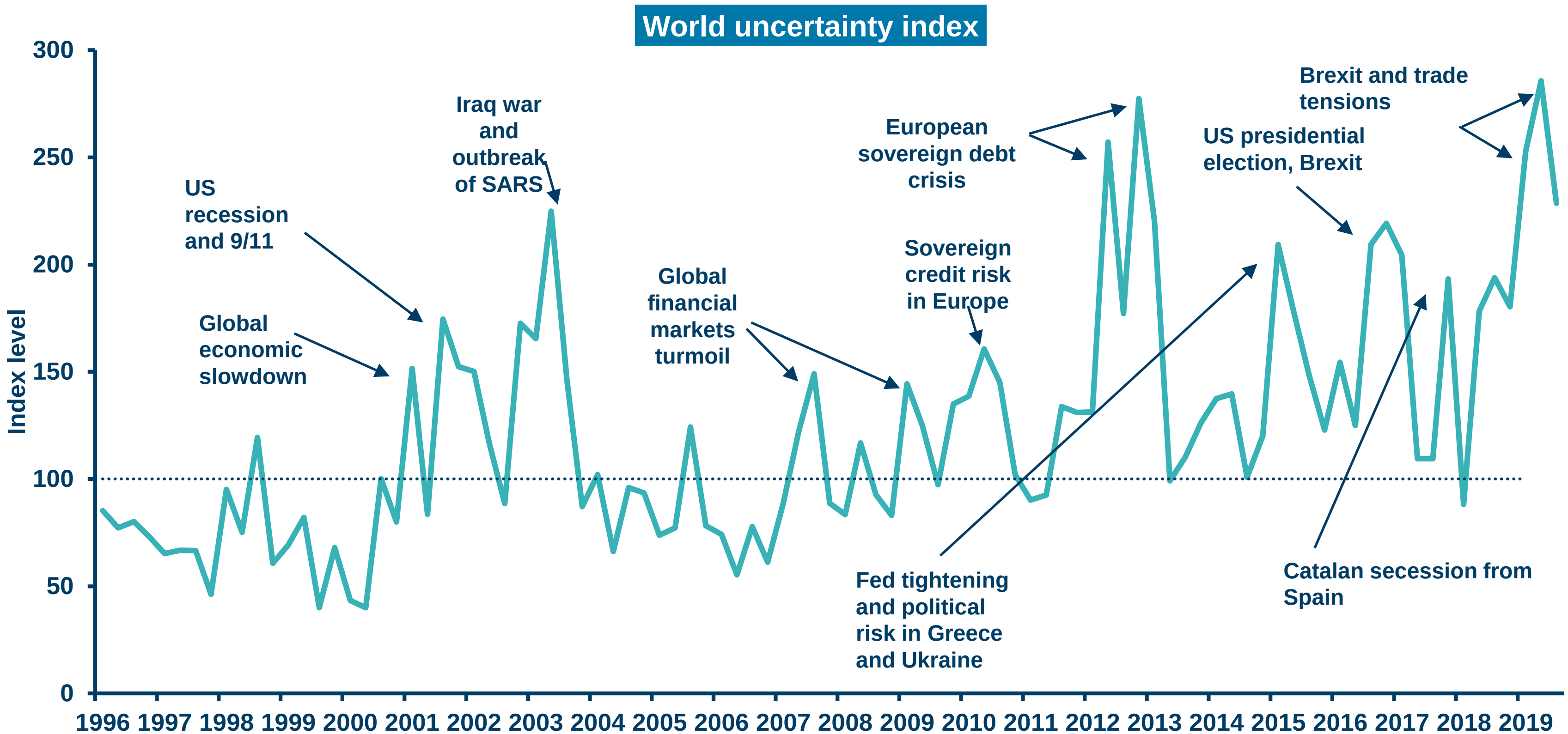
Tightening

DM: Central banks to stay dovish; further rate cuts are likely, with the Fed having further room to cut

EM: Further easing is likely, especially in countries that have not been stimulating enough compared to their economic potential

Source: Amundi as of 30 November 2019. Indicative map for monetary policies. A reduction or end of quantitative easing is interpreted as tightening. Fed: Federal Reserve; BoE: Bank of England; PBoC: People’s Bank of China; BoJ: Bank of Japan; BCB: Central Bank of Brazil; CBR: Central Bank of Russia; ECB: European Central Bank; RBI: Reserve Bank of India; BoC: Bank of Canada; RBA: Reserve Bank of Australia.

Some recent easing in political risk, but still very high



» Uncertainty surrounding trade developments remains high, and the US election will likely dominate the news flow in the second part of 2020.

Source: H. Ahir, N. Bloom, and D. Furceri (2018), “World Uncertainty Index”, Stanford mimeo, Amundi as of 4 November 2019.

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Debt overhang and 'de-globalisation'

Trade protectionism
Middle East tensions
Brexit
Idiosyncratic stories
Market sell-off/liquidity
Policy mistakes

Central bank independence
De-globalisation
Debt sustainability
Weak demographics, low productivity
Economic transition in China
Climate change

» In the medium term, the threat to debt sustainability is a key risk. In H1 2019, the total debt reached new highs at $250tn. De-globalisation is another long-term trend that is reshaping global economic equilibria. Climate-related topics could become prominent on central banks' agendas.

Source: Amundi, as of 30 November 2019.

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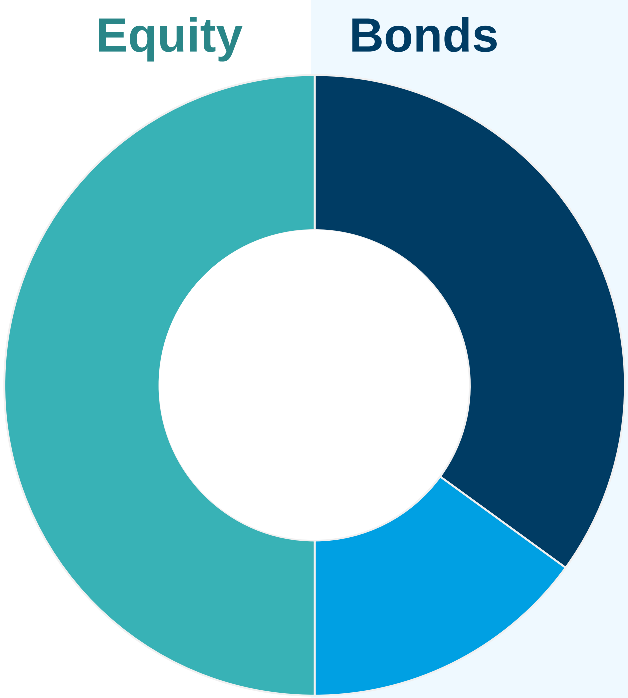
How to play fixed income markets

Portfolio construction for a late phase of the cycle with dovish central banks in action



CORE Allocation

- Seek decorrelation to equities
- High-quality assets
- Focus on alpha generation, with risk management and active allocation (across regions, sectors and yield curves)

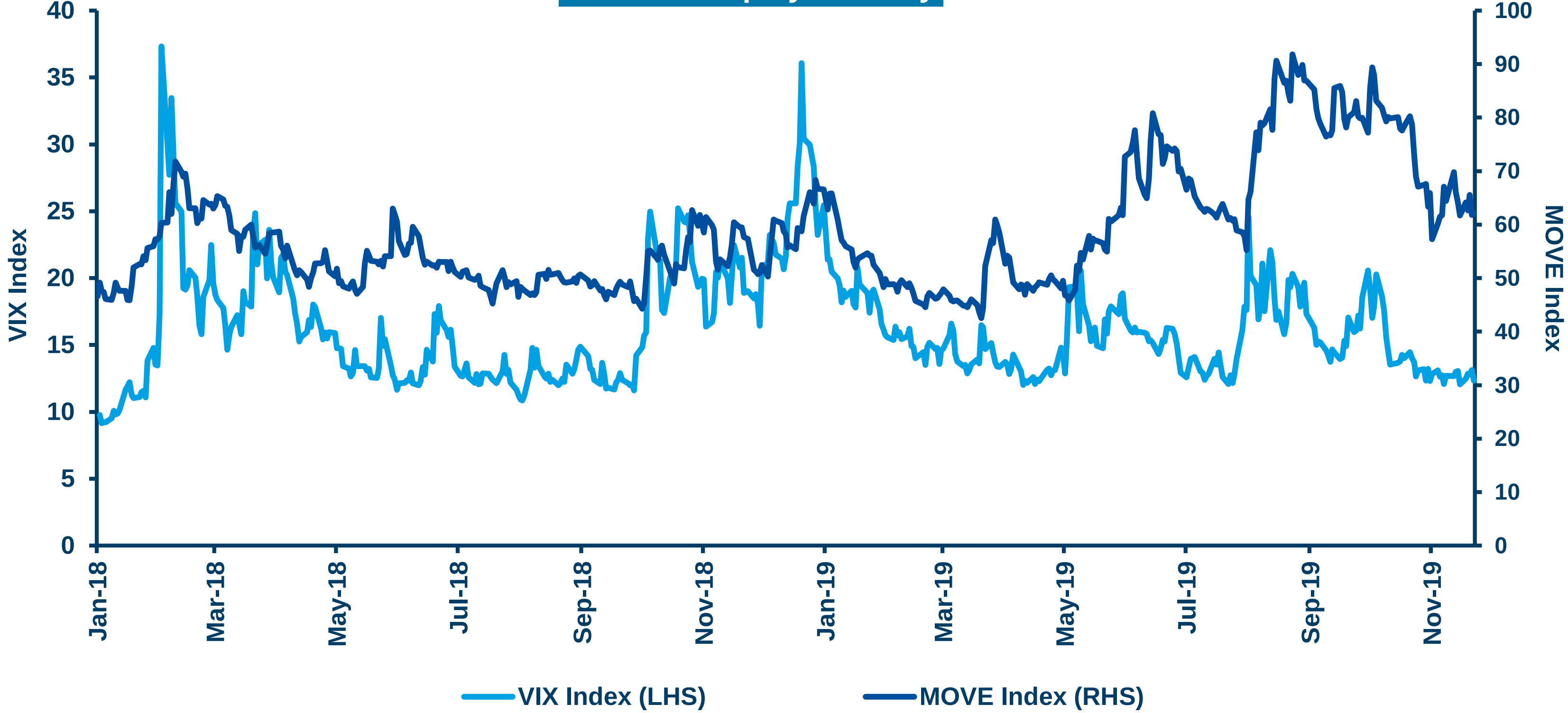
INCOME Satellite

- Explore higher-income spaces (HY, subordinated bonds, credit continuum)
- Focus on selection and liquidity management

Source: Amundi, as of 30 November 2019, For illustrative purposes only.

'Core': Stay flexible to deal with possible rise in volatility…

Bond and equity volatility

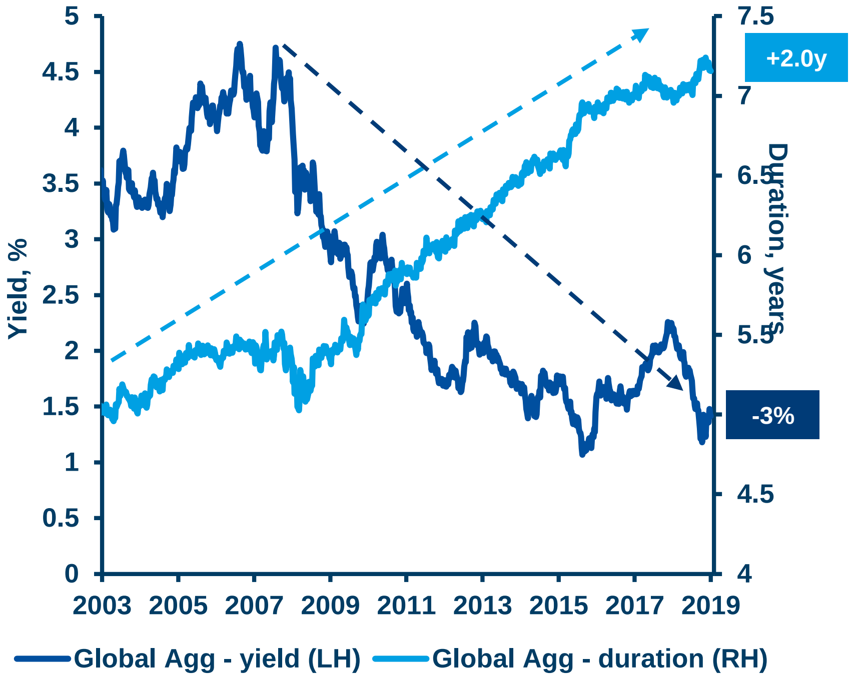


» Bond volatility has trended higher in 2019. It is possible we could see a resurgence in volatility in 2020, when expectations will likely adjust to diverging scenarios that could materialise next year.

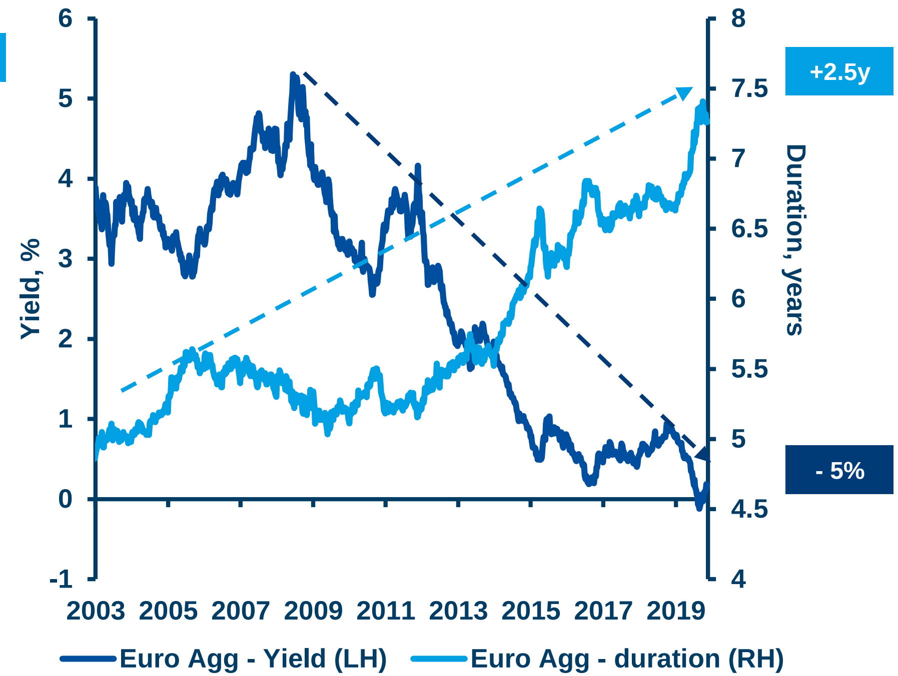
Source: Bloomberg, Amundi. Data as of 25 November 2019. MOVE Index is the Merrill Lynch Option Volatility Estimate for the US Treasury. VIX is the CBOE volatility index. VIX Index is a measure of market expectations of near-term volatility for the S&P500 (US equity).

... amid low yields and high duration risk

Barclays Global aggregate duration vs yield



Barclays Euro aggregate duration vs yield

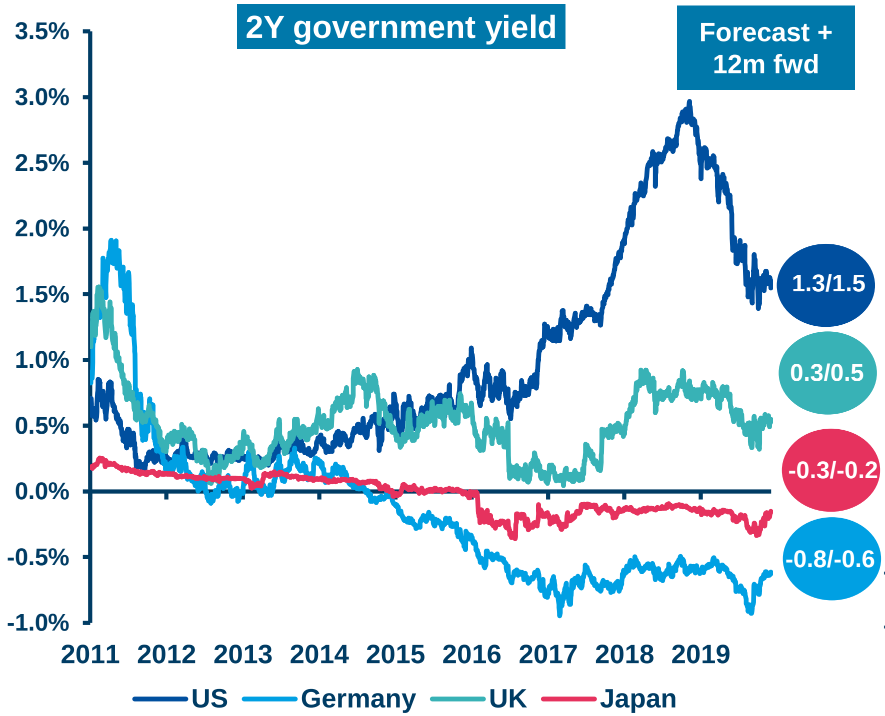


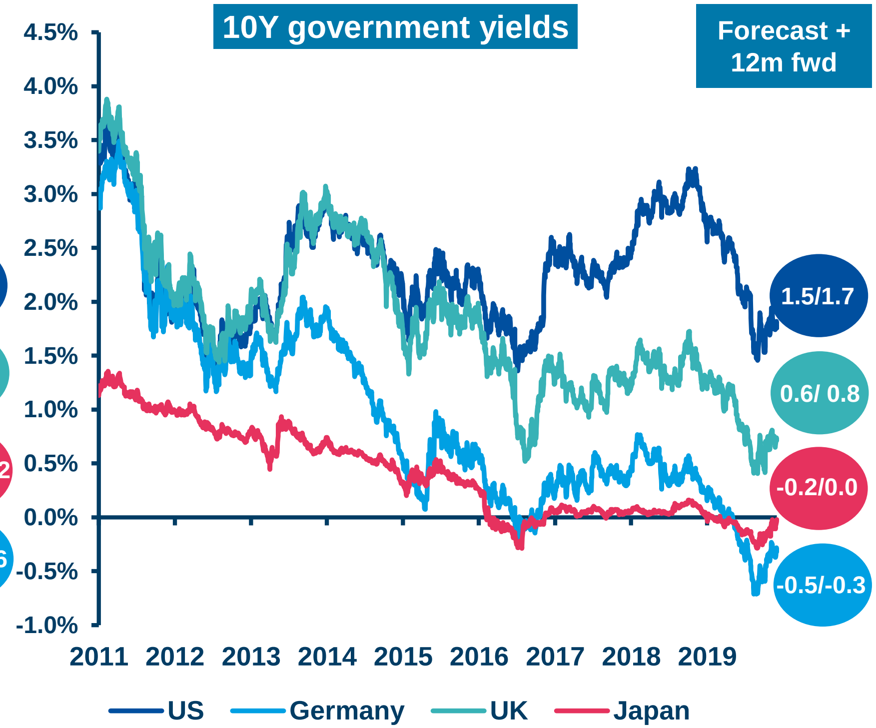
» In aggregate indexes, duration is close to all-time highs and yield at historical lows. An active-management approach is needed to deal with possibly higher volatility in bond markets. Take advantage of negative rates.

Source: Bloomberg, Amundi. Data as of 25 November 2019.

Source: Bloomberg, Amundi. Data as of 25 November 2019.

‘Core’: Opportunities from yield differentials and movement



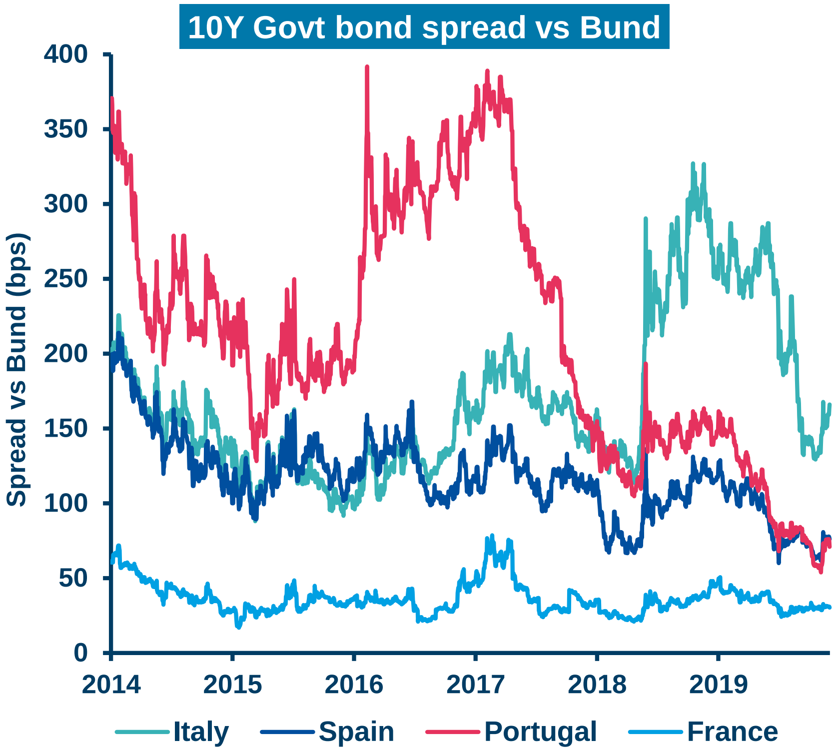


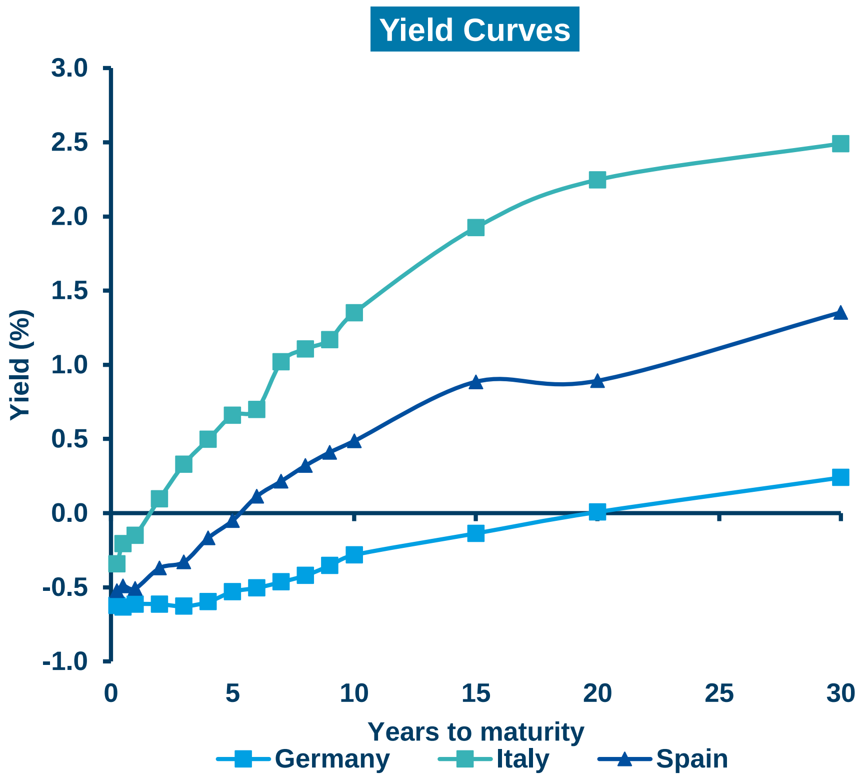
» Investors could play interest rate differential and possible adjustments in bond yields, depending on how different scenarios play out. We believe that currently investors should take a short duration stance in Europe and Japan, and we favour US duration.

Source: Bloomberg, Amundi Research forecasts. Data as of 3 December 2019.

Source: Bloomberg, Amundi Research forecasts. Data as of 3 December 2019.

‘Core’: Opportunities in EU peripherals and curve flattening



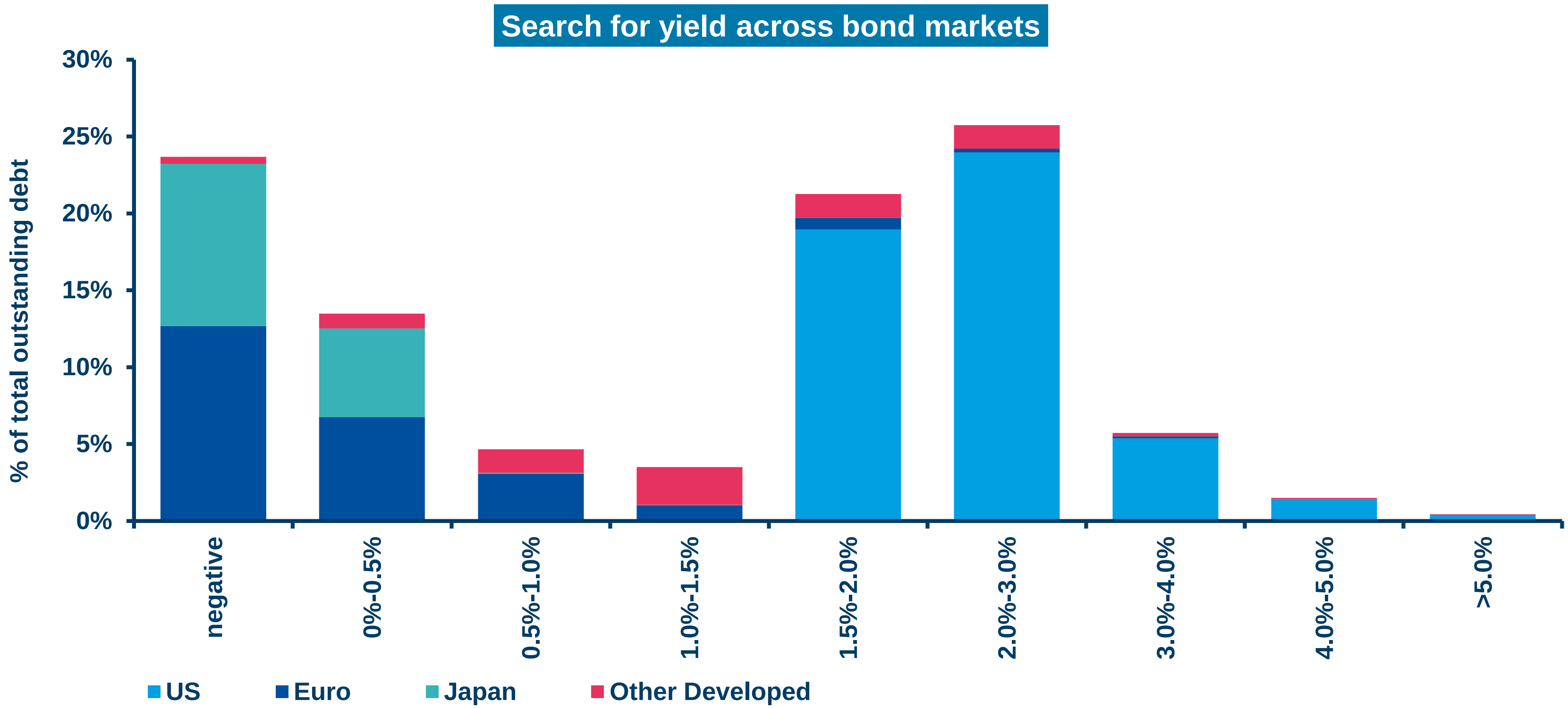


» Euro fixed income has been supported by ECB accommodation. This should benefit the peripheral bond market, which is favoured in the search for yield. We see opportunities in curve flattening.

Source: Bloomberg, Amundi. Data as of 3 December 2019.

Source: Bloomberg, Amundi. Data as of 3 December 2019.

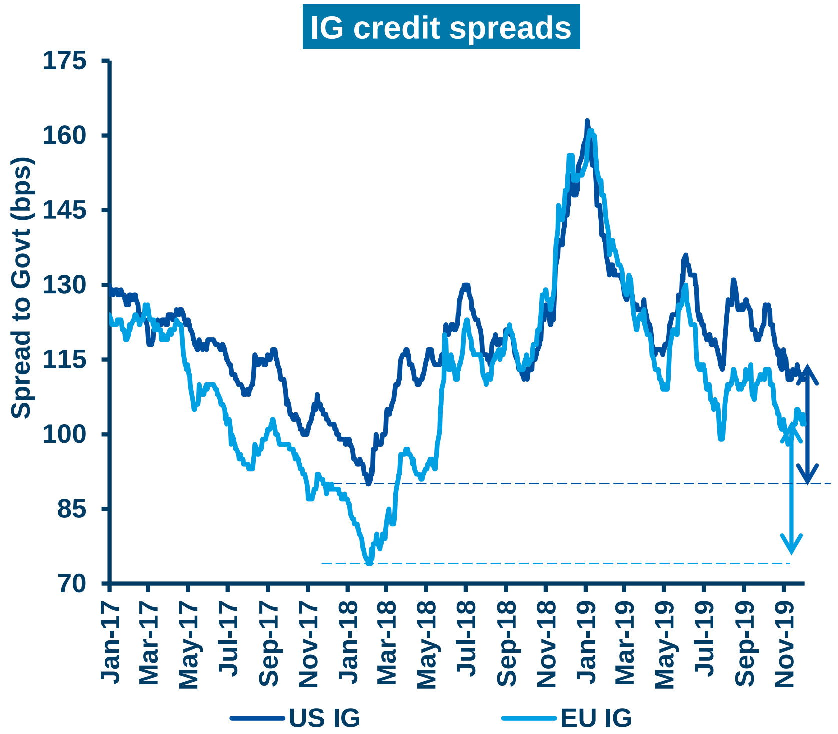
Income: The search for yield is set to continue globally

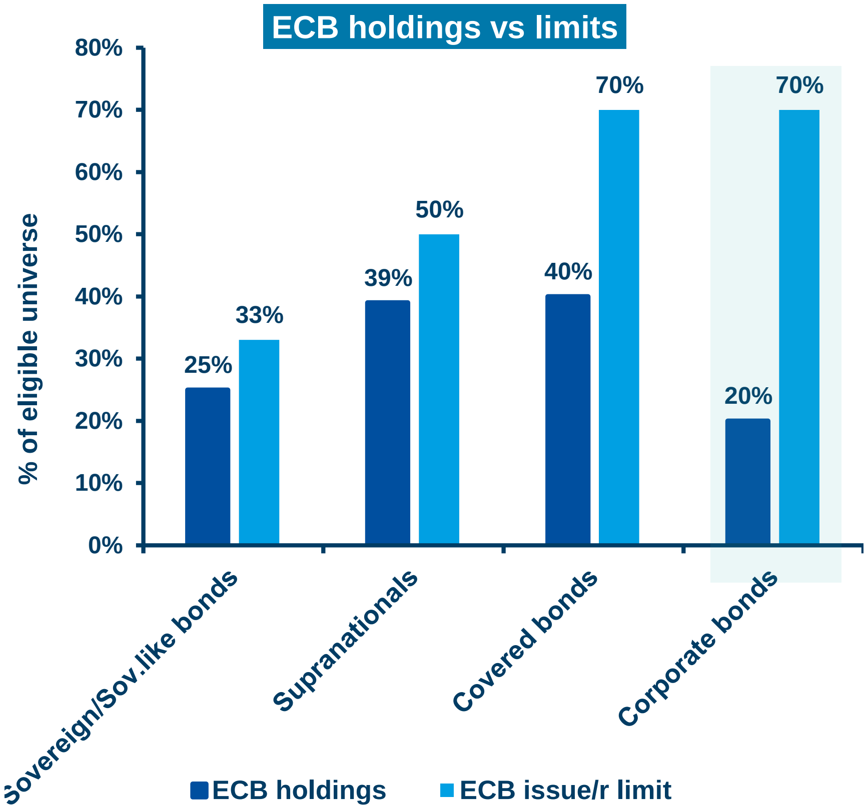


» The search for yield will continue in 2020 in developed markets. Investors should look for opportunities in the global credit investment-grade market and in higher-yielding segments.

Source: Amundi Research, analysis on Bloomberg data. BofA-ML indices (investment grade). Data as of 31 October 2019.

Income: IG credit supported by dovish central banks





» Expectations of further Fed and ECB easing should support credit, especially in Europe. We are positive on EUR IG: the ECB has further room to increase its holdings in corporate bonds from current levels.

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

Source: BofAML indices, Bloomberg, Amundi. Data as of 22 November 2019.

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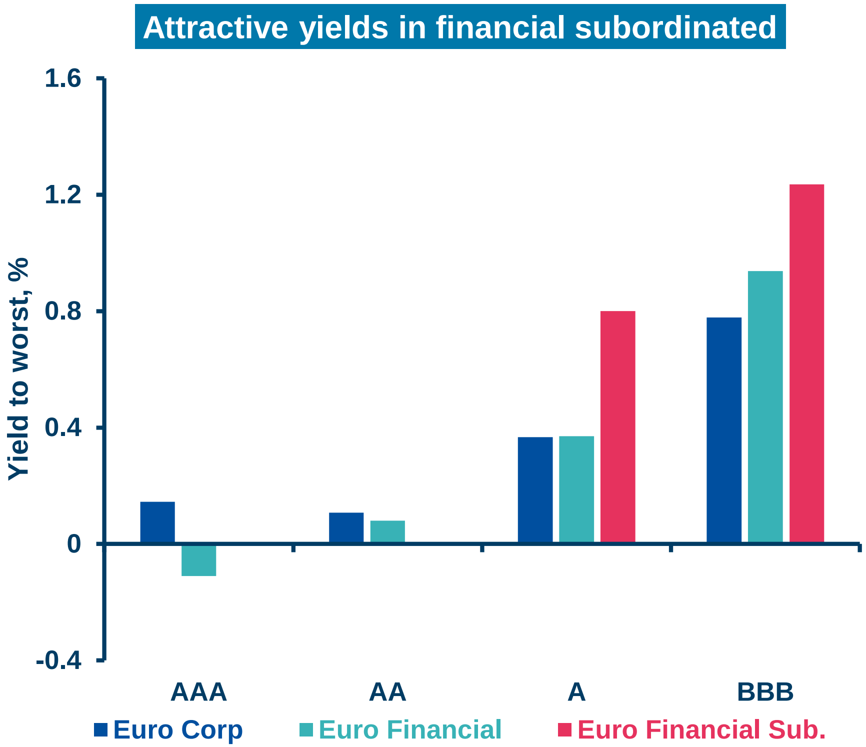
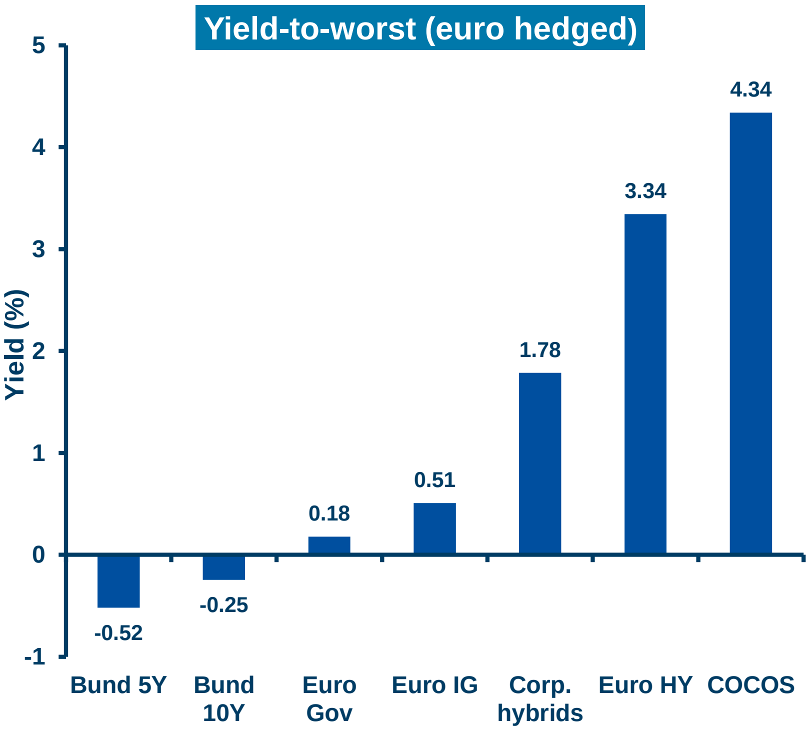
Income: Broaden the sources, with a selective focus



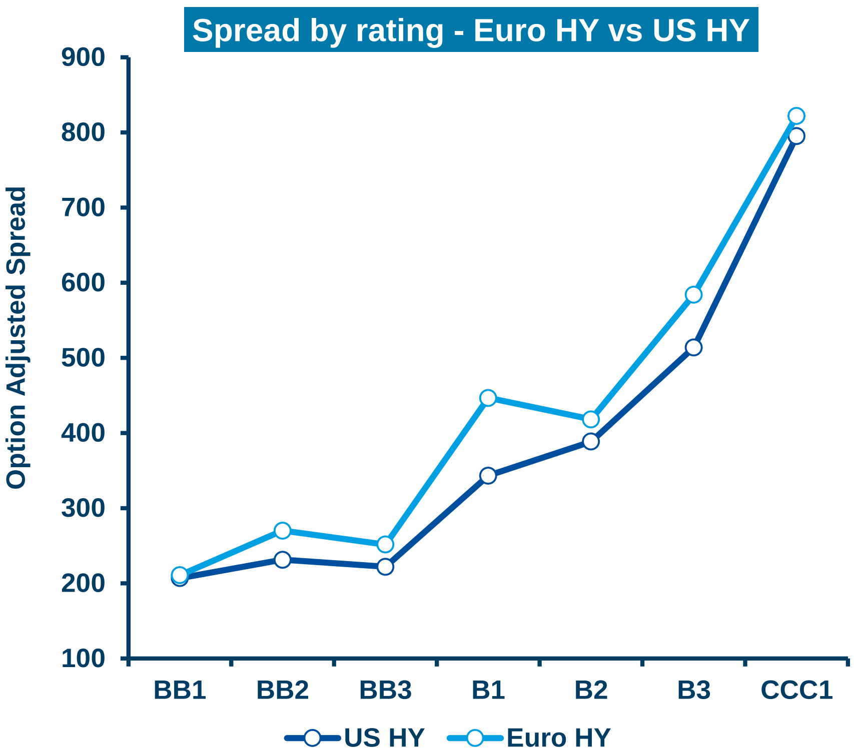


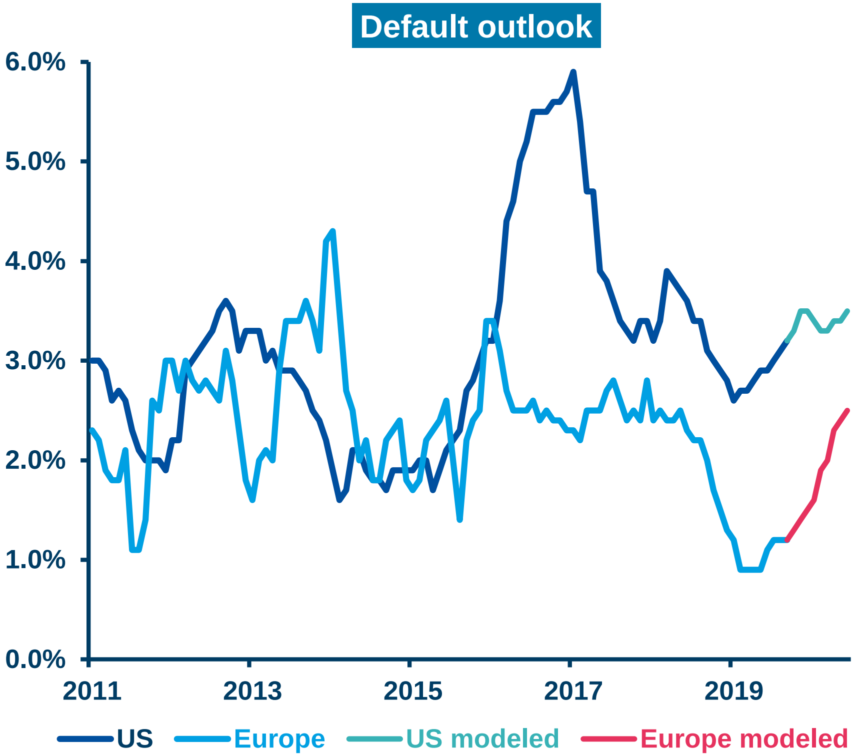
Subordinated financial bonds are attractive for investors in search of income, as they offer higher yield for any issuer rating. Credit selection is essential moving down the rating scale.

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

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

Income: HY credit with selection and focus on liquidity





» While dovish central banks and negative rates support the environment for HY, idiosyncratic and liquidity risks persist and have to be carefully monitored. We expect some deterioration in the default outlook for 2020. In the US, defaults are mainly an energy story. That's why a strong focus on credit selection is paramount in a late cycle.

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

Source: Moody's, Amundi Research. Data as of 30 November 2019.

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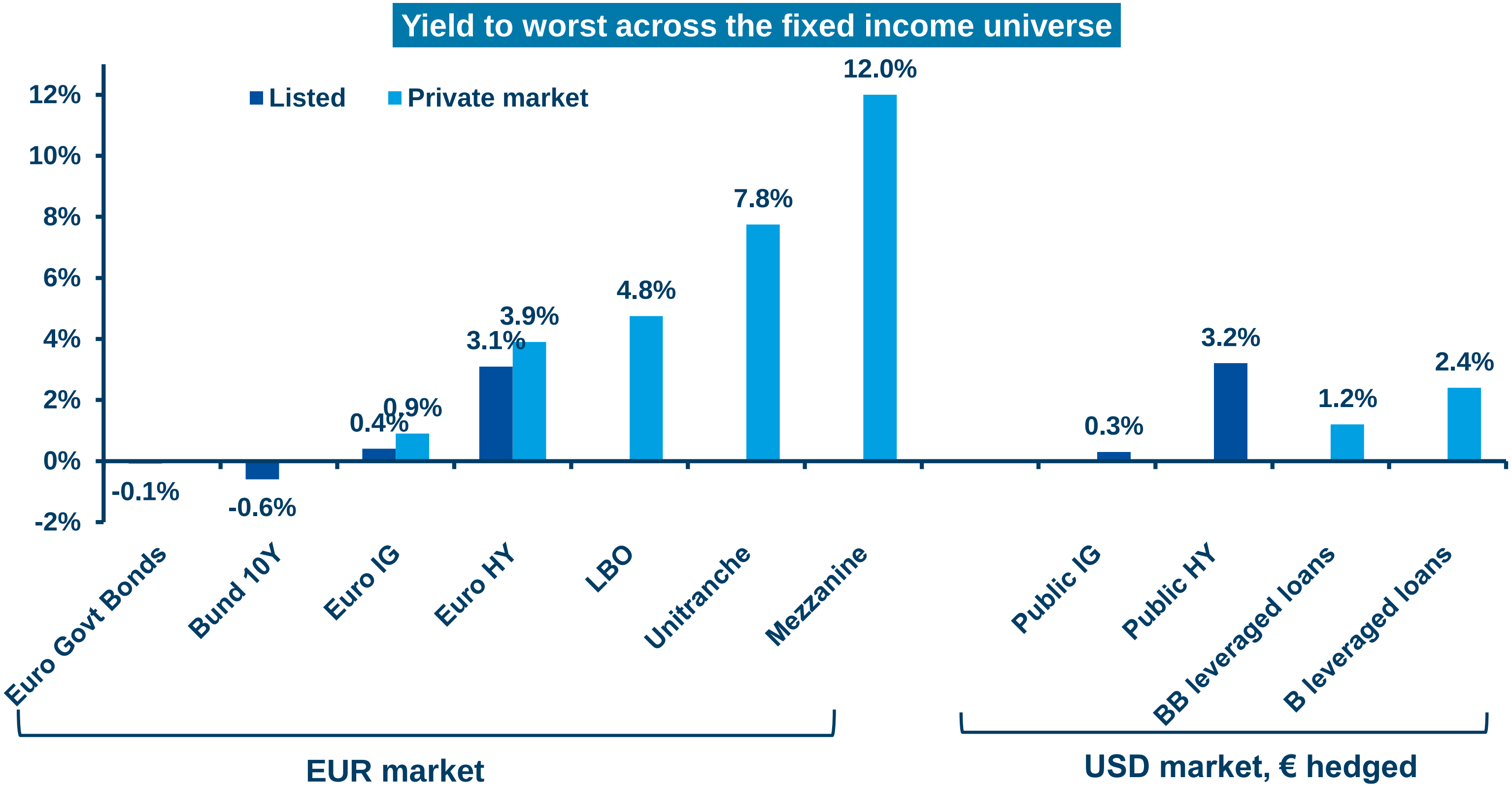
Income: Explore the credit continuum in Europe



» A combination of listed and private debt could be attractive in the search for yield for investors with the appropriate investment horizon.

Source: Amundi, data as of 14 November 2019. Past performance does not prejudge future performance. Mezzanine debt is an estimate based on past deals. **Past performance is no guarantee of future results.**

A strong focus on liquidity management is needed

1. **Liquidity watch.** Constant monitoring at the global investment committee level of liquidity in the market and in all investors' portfolios

2. **Swing pricing.** Aims to protect existing investors from the performance dilution effects they may suffer as a result of subscription/redemptions by other investors in the fund

3. **Liquidity buffer.** Defined as the short end of the counter-balancing capacity per fund/investment process under stressed markets

4. **Liquidity crisis management.** One-off process aimed at coordinating teams in an extreme liquidity crisis

Source: Amundi.

Conclusions

How to play

Core Bond Allocation

- Focus on high-quality assets
- Adopt an unbiased approach to get the most from aggregate bond markets
- Flexibility and diversification as key levers to generate value

Income Satellite Allocation

- Explore opportunities in credit markets (IG, HY, sub bonds, and credit continuum)
- Focus on credit selection
- Include liquidity considerations in the selection of investment ideas

Source: Amundi, as of 30 November 2019.

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Fixed Income Publications

Q3/Q4 2019

Date	Title
22 Nov 19	2020 Investment outlook: be agile to cope with diverging scenarios
8 Nov 19	Renewed expansion of Fed balance sheet will not be QE but will affect markets
6 Nov 19	A Brexit deal: Probably but not just yet
4 Nov 19	High Yield: deep diving needed due to a more uncertain outlook
30 Oct 19	Brexit extension will ease uncertainty looming on UK assets
18 Oct 19	Italy: few ambitions from the new budget framework
14 Oct 19	Liquidity dilemma needs a regulatory response
11 Oct 19	Trump impeachment is likely, but impact on financial markets would be short-lived
24 Sep 19	The Fed cuts rates but the market expects more
15 July 19	Revisiting fixed income opportunities after the European institution appointment

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Indexes reference & definition

Fixed Income Market Indexes (p. 3)

Euro Cash 3m = JPMorgan Cash Euro 3M; USD Cash 3m = JPMorgan Cash USD 3M; EMU Govies = JPM GBI EMU in LOC; US Govies = JPM GBI US in LOC; Japan Govies = JPM GBI Japan in LOC; UK Govies = JPM GBI UK in LOC; Euro Infl. Link = Bloomberg Barclays Euro Govt Govt Inflation-Linked All Maturities; US Infl. Link = Bloomberg Barclays US Govt Inflation-Linked All Maturities; Jap. Infl. Link = Bloomberg Barclays Japan Govt Inflation-Linked All Maturities; UK Infl. Link = Bloomberg Barclays UK Govt Inflation-Linked All Maturities; Euro IG = ICE BofAML Euro Corporate; US IG = ICE BofAML US Corporate; Euro HY = ICE BofAML Euro High Yield; US HY = ICE BofA-ML US High Yield; EM Govies HC = JPMorgan EMBI Global Composite; EM Govies LC = J.P. Morgan GBI-EM Global Composite LOC.

Definitions

- **Alpha:** The additional return above the expected return of the beta-adjusted market return; a positive alpha suggests risk-adjusted value added by the money manager compared to the index.
- **Basis points**: One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Correlation:** The degree of association between two 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 (perfectly negative correlated) through 0 (absolutely independent) to 1 (perfectly positive correlated).
- **CoCo bond:** A contingent convertible bond (CoCo), also known as an enhanced capital note (ECN), is a fixed-income instrument that is convertible into equity if a pre-specified trigger event occurs.
- **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.
- **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.
- **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.
- **LBO:** Leveraged buyout. It is the acquisition of another company using borrowed money to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.
- **Mezzanine:** Mezzanine debt occurs when a hybrid debt issue is subordinated to another debt issue from the same issuer. Mezzanine debt has embedded equity instruments, often known as warrants, which increase the value of the subordinated debt and allow greater flexibility when dealing with bondholders.
- **Spread:** Difference between two prices or interest rates.
- **Unitranche debt:** Unitranche debt is a hybrid loan structure that combines senior debt and subordinated debt into one loan, allowing banks to compete better against private debt funds.
- **Volatility** is 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.

Important Information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management and is as of 30 November 2019.

Date of First Use: 6 December 2019.