Confidence must be earned

Amundi ASSET MANAGEMENT

8 November 2019

Renewed expansion of Fed balance sheet will not be QE but will affect markets

INVESTMENT TALKS

Paresh UPADHYAYA
Director of Currency Strategy, US Portfolio Manager

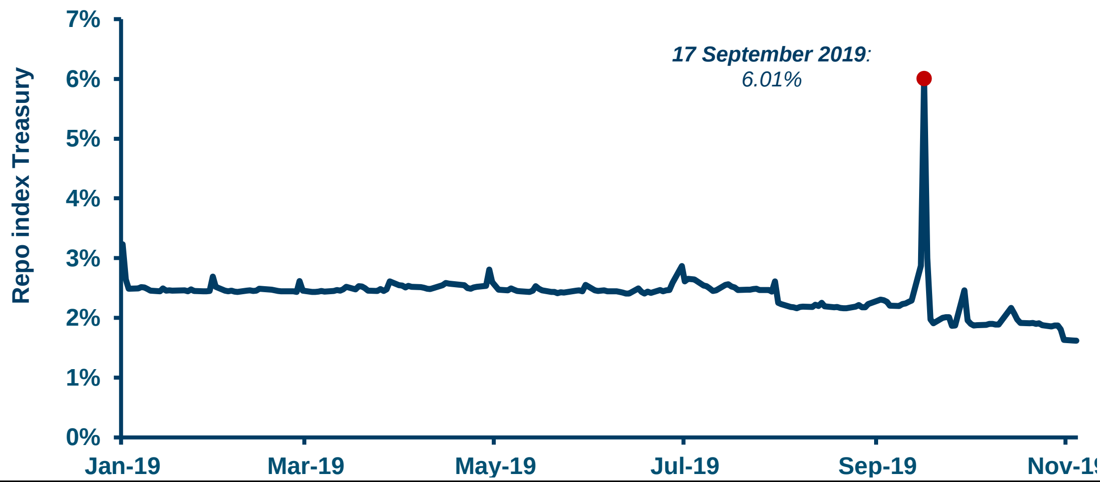
Christine TODD
Head of Fixed Income, US

- ***Recent Fed action***: *On 30 October the Federal Reserve cut the federal funds rate for the third time this year, while hinting at a pause over the next few months. The rate cut followed the Fed's announcement on 11 October that it will address a liquidity shortage causing volatility in the overnight loan market by buying $60 billion per month in Treasury bills until Q2 2020 and support overnight repo operations through January 2020.*
- ***Monetary policy impact:*** *The most recent Fed balance sheet expansion is not meant to be Quantitative Easing[1], which the Fed implemented following the 2007-08 financial crisis. Current policy is not aimed at lowering longer-term interest rates and term premium to stimulate the economy. Instead, the Fed is calibrating the optimal size of its balance sheet and ensuring adequate liquidity in the system.*
- ***Market impact***: *The Fed could end up owning about 20% of the T-bill market by mid-2020, up from the current 1% according to Amundi estimates, potentially driving T-bill yields lower. This may create investment opportunities among shorter duration fixed income securities and sectors where the liquidity premium remains attractive, such as securitised assets, particularly where risk exposures are connected to the strength of the US consumer. Investors should reduce exposure to overall interest rate duration, as yields could bottom out, and to the corporate bond market, where increased scrutiny and selection are required as valuations have become rich in response to the global thirst for yield.*

Why has the Federal Reserve announced renewed balance sheet expansion?

On 11 October 2019 the Federal Reserve announced it would begin buying Treasury bills (T-bills, bonds with duration of up to one year) to inject liquidity and stability into the overnight loan market and expand its balance sheet.

Fed was spurred to act when the repo rate spiked



Source: Bloomberg, Amundi as of 5 November 2019.

The Fed's decision originates from the squeeze in the overnight repo market in September, when the cost of borrowing cash overnight jumped to 6% from around 2%, indicating a liquidity

[1] 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.

shortfall in the overnight loan market. The confluence of temporary and fundamental factors caused such dislocation. Cash exiting the market for corporate tax payments and US Treasury settlements were not offset by Global Systematically Important Banks reserves or a right-sized Fed balance sheet. Upward pressure on money market rates spilled over into the federal funds market rates. The Fed responded belatedly by injecting liquidity into the overnight lending market. This initial stop-gap activity was not enough to settle the repo market, prompting the Fed to announce planned purchases of $60 billion per month in T-bills at least through Q2 2020 and support for overnight repo operations at least through January 2020.

"The newly announced Fed action is not QE."

How does this action differentiate from QE?

There is some confusion among investors about whether the Fed's decision to buy T-bills constitutes QE. By its broadest definition, QE is an unconventional monetary policy tool under which the central bank purchases government securities or other financial securities in order to inject liquidity into the system and help an economic recovery. This is not the goal of the most recent Fed action, which, as such, cannot be seen as a new round of QE. Actually, the Fed stated that these actions are purely technical to support the effective implementation of the Federal Open Market Committee's (FOMC) monetary policy and **does not represent a change in the US monetary policy stance.** By buying T-bills with duration of up to one year, the Fed is not trying to lower longer-term interest rates and term premium to stimulate the economy. Instead, the Fed is calibrating the optimal size of its balance sheet. Additionally, the primary purpose of these operations is to ensure adequate liquidity in the system, which is not, by definition, QE's goal. According to the Fed, the T-bill programme "*is designed to achieve ample reserve balances at or above the level that prevailed in early September". *The Central Bank *"will conduct term and overnight repo operations at least through January to ensure that the supply of reserves remains ample even during periods of temporary, but pronounced, increases in our non-reserve liabilities, and to mitigate the risk that money market pressures adversely affect monetary policy implementation."*

"The most recent Fed action should counter tightness in the US money market and remove some support to the USD."

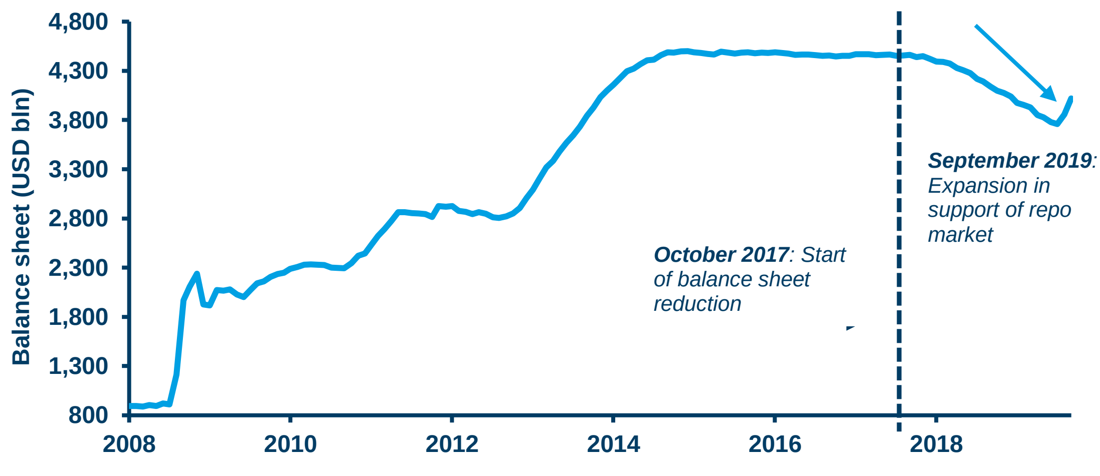
Is the Fed's decision unexpected?

No, the expansion of the Fed's balance sheet is not an unexpected event. In July, the FOMC concluded its balance sheet reduction program which had been in place since October 2017. The Fed clearly indicated that, after a time, it would commence increasing its securities holdings to maintain reserves at a level consistent with an ample-reserves regime.

How will the Fed's action impact market liquidity and USD trends?

Market liquidity is crucial to facilitate normal operations and asset price movements in financial markets, as highlighted in our recent piece "*Liquidity dilemma needs a regulatory response*".

Fed's balance sheet expansion in support of the repo market



Source: Bloomberg, Federal Reserve, Amundi as of 30 October 2019.

"Fixed income investors could capture value from oversold sectors and securities during dislocations."

As BIS *research* showed, flat yield curves, tight credit spreads and lower trading volumes may drive some players out of the market, possibly exacerbating market malfunctioning when central bank balance sheets are unwound. This is what happened following the latest Fed rate cut in September, which forced the Fed to inject $140 billion of liquidity into the market.

How will the Fed's approach to liquidity impact the USD?

In the coming months, the Fed purchases of T-bills will total about $350-500 billion, building an adequate reserve buffer which should help stabilise the repo market and counter tightness in the US money market. This should remove one of the factors that have supported the USD so far this year, and could **possibly drive the currency lower**. Also, the Fed's balance sheet will rise from around $4 trillion currently close to its peak of $4.5 trillion, facilitating a likely dollar weakness.

Which is the impact of the latest Fed's purchasing programme on the US fixed income market and how could investors benefit?

At the current purchasing pace, the Fed could own about 20% of the T-bill market by mid-2020 up from the current 1%, according to Amundi estimates. Such demand **will likely drive T-bill yields lower**, possibly significantly lower. This could spill over into short-term Treasury coupons (1-3y) and short-dated agency paper.

One of the indirect consequences of the Fed's repo action could be the **steepening of the yield curve**, as purchases of T-bills could help anchor short-term Treasury bond yields. This would allow the mid- to long-end of the US government bond market to react to inflation and global factors, such as emerging trends in the US-China trade tensions and Brexit.

Fixed income investors should be positioned not only to weather periods of market dislocation -- as experienced in the US repo market in September -- but also to **capture value from oversold sectors and securities during dislocations. They may also consider positioning for a decline in the dollar and a steeping of the yield curve in response to the Fed's current policy. Being agile in portfolio management will be key for fixed income investing in 2020.**

Market segment	Opportunities in the US fixed income market
Treasury market	Take profit from lower yields – back close to historical lows -- and flatter US yield curve caused by an excess of capital flows to the US Treasury market. Reduce exposure to overall interest rate duration, as yields could bottom out thanks to recent Fed action which creates a supportive environment for economic growth
IG corporate bonds	Reduce exposure, increase scrutiny and be selective as valuations have become rich in response to the global thirst for yield
Securitised assets	Liquidity premium remains attractive, particularly where risk exposure is connected to the strength of the US consumer

Source: Amundi. Data as of 6 November 2019.

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at **www.amundi.com**

Definitions:

- **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.
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **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.
- **Term premium**: The difference between the yield of a longer-maturity bond and the average expected risk-free short-term rate for that maturity.
- **Quantitative Easing (QE):** QE is a monetary policy instruments used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.

Chief Editors

Pascal BLANQUÉ
Chief Investment Officer

Vincent MORTIER
Deputy Chief Investment Office

Amundi
ASSET MANAGEMENT