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Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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Central banks in focus: assessing the path ahead for the Fed

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US economy: *We expect the US economy to grow above potential in 2019 and to gradually converge to its long-term growth rate of around 2% in 2020 as the boost provided by fiscal expansion in 2018 will gradually lose steam.*
The path ahead for the Fed: *With the economy running above potential and the labour market becoming tighter, the Fed may choose to continue normalising and hiking rates until signs of a deceleration in growth materialise. The Fed's expectations regarding inflation are broadly aligned with our own forecasts (2.2% Amundi vs 2.3% Fed median), but risks remain tilted to the upside. In our view, the Fed will be more cautious than in 2018 and we expect a pause in the hiking cycle by mid-2019 at the latest. The Fed has also made clear that it will not change its strategy for shrinking the balance sheet:*
Financial conditions: *The rise in credit spreads represents a de facto tightening of credit conditions that the Fed can no longer ignore. The amount of investment-grade BBB corporate bonds is at a record level. Should the economy experience a sharp slowdown, these bonds would be at risk of downgrade to high yield (HY), potentially causing forced sales and therefore a sudden tightening of all credit conditions. Hence, the Fed will have to monitor the ability of companies to absorb a further tightening of their financing conditions. We also think that the huge rise in US funding needs in a context of lower liquidity will likely continue to be satisfied by dollar investors and will contribute to a tightening in global financing conditions. Hence, we see the potential rise in long-term core government bond yield as very limited.*
Political interference: *Although we see the Fed defending its independence, there is the risk that political interference could prove counterproductive.*

US growth is still sound, but wage pressures are building. Do you see a risk that the Fed could be behind the curve? What is your outlook for growth and inflation in 2019?

DB/AU: We expect the US economy to grow above potential in 2019 and to gradually converge to its long-term growth rate of around 2% in 2020, as the boost provided by fiscal expansion in 2018 should gradually lose steam. As a result, domestic demand will gradually slow. With the economy running above potential and the labour market becoming tighter, the Fed may choose to continue normalising and keep raising rates until signs of a deceleration in growth materialises. Having said that, we expect the Fed to become much more cautious. Global growth is not as supportive as it was in early 2018. Monetary and financial conditions have tightened quite substantially over the past few months and this will impact growth with a lag of several months. The impact of fiscal policy is expected to vanish in 2019. Regarding inflation, the Fed's expectations are broadly aligned with our own forecasts (2.2% Amundi vs 2.3% Fed median) as well as regarding inflation Core PCE (2.0%); while risks remain tilted to the upside, production bottlenecks, higher wage dynamics, and increased production costs from tariffs could weigh on companies, and some of the pressure could be transferred to consumer prices. However, the Fed will be more cautious than in 2018. We expect a pause in mid-2019 at the latest. Credit conditions will be a key determining factor regarding the Fed's monetary policy looking ahead. In 2018, the Fed looked to rebalance the policy mix (excessively expansionist at this stage of the cycle) and to regain some room for manoeuvre in terms of monetary policy. With less support from fiscal policy likely ahead, we expect the Fed to become more cautious.

"The Fed will be more cautious than in 2018. We expect a pause in mid-2019 at the latest".

"For the Fed, it is not so much a debate about the level of the equilibrium rate (the measure of which is known to be very uncertain), but about the ability of companies to absorb a further tightening of their financing conditions".

Do you see the tightening of financing conditions as a concern for the Fed?
DB/AU: From a macroeconomic standpoint, the US economy remains solid and calls for the Fed to continue raising rates. But, the rise in credit spreads represents a de facto tightening of credit conditions that the Fed can no longer ignore.
Indeed, outstanding bond debt has increased significantly during this cycle, especially over the recent period, for companies with low profits and high debt. The amount of risky debt now stands at over $2,300bn. At the same time, we note that investment-grade bonds (BBB) have reached record levels (35% of corporate bond debt). A sharp slowdown in the US economy would quickly shift some of these bonds into the HY category, causing forced sales of the latter and thereby a sudden tightening of all credit conditions. Against this backdrop, for the Fed, it is not so much a debate about the level of the equilibrium rate (the measure of which is known to be very uncertain), but about the ability of companies to absorb a further tightening of their financing conditions that does not weigh on their investment and therefore on growth prospects.

What are the supply/demand dynamics driving the US Treasury market?
VA: Jerome Powell was clear that the Fed won't change its strategy for shrinking the balance sheet:

- This is a key element for the fixed income market. The pace of the reduction of the Fed balance sheet is accelerating to about $500bn in 2019 (after $350bn in 2018). This is a big swing considering that until 2017, there was massive balance sheet expansion by the major central banks (Fed, ECB, BoJ). Total assets on the Federal Reserve's balance sheet increased from $870bn on August 2007 to $4.5tn in January 2015.
- Net issuance will, at the same time, remain significant in 2019, at around $1.2tn. US debt supply has jumped this year to fund the US administration's expansionary policy. US net Treasury issuance has nearly doubled in 2018, to more than $1tn, with a dramatic increase in T-bills ($0.4tn).

"US Treasury auctions have seen steady demand, supported by US households, which is expected to persist in 2019 and to support bond yields".

Through 2018, US Treasury auctions have seen steady demand, supported by US households. The short part of the US curve offers an attractive yield for dollar investors. On the other hand, growth in foreign ownership has stagnated and the main foreign holders of Treasuries, China and Japan, have shrunk their portfolios of US government bonds this year. European and Japanese investors face some of highest hedging costs since the previous economic crisis.
All in all, we think that this huge rise in US funding needs in a context of lower liquidity will likely continue to be satisfied by dollar investors and will contribute to a tightening in global financing conditions. Thus, we argue that the potential rise in the long-term core government bond yield will be very limited.

How do you assess the risk of rising political interference, and how could this influence Fed decision-making going forward?

"Although we see the Fed defending its independence, there is the risk that political interference could prove counterproductive".

DB: We think that the Fed is defending its independence at a time of an uneasy relationship with a president who has openly criticised the CB. It is the case, however, that Donald Trump does not really have the means – without a majority in Congress – to threaten Fed independence. His remarks are therefore an attempt to intimidate the FOMC. That said, looking ahead, if Donald Trump were to further increase the pressure just as inflationary pressures intensify, it could encourage the Fed to raise its key rates more than it might otherwise in the absence of any political pressure. This is a risk that we cannot completely rule out. An increase in political interference could prove counterproductive regarding US economic performance.

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