Confidence must be earned

Amundi ASSET MANAGEMENT

Q3 2019

Fixed Income Charts and Views

Ultra dovish Central Banks put fixed income investing back to the core

Investment Insights | Market Stories

Fixed income back to the core: Search for yield, flexibility, and ESG are major themes

Eric Brard
Head of Fixed Income

A slowdown in global growth, with subdued inflation and dovish central banks (CB) committed to avoiding further economic deceleration, is a trend that, in our view, should remain favourable for bond investors. On one side, this should limit the upside in core bond yields and, on the other, support the credit market, although we are aware that the spread compression in this first part of the year has been very strong and that an increasingly selective approach will be crucial to exploiting pockets of value.

Other dominant factors within the fixed income environment are the increased role of politics, the still present short-term downside risks regarding the economy, the high level of debt globally, and, moving towards the long term, rising acknowledgment of climate and societal-related risks.

Against this backdrop, rethinking fixed income investments as a core part of investors' portfolios is crucial both to deliver attractive risk/adjusted returns and to seek protection and effective diversification in phases of market turmoil.

We identify three recurring themes for investors:

- *The search for yield further emphasised by the rally in core bonds.*
- *The need to embrace a flexible and diversified approach in a late phase of the cycle when sudden changes in market sentiment are more likely.*
- *The emergence of ESG and climate change as key topics in portfolio construction.*

This publication combines views from our global teams of portfolio managers, macro-economists, strategists and Investment Insights specialists with the aim of providing our ideas with regard to investing in fixed income markets for the months ahead. We hope you find the information helpful,

Eric Brard

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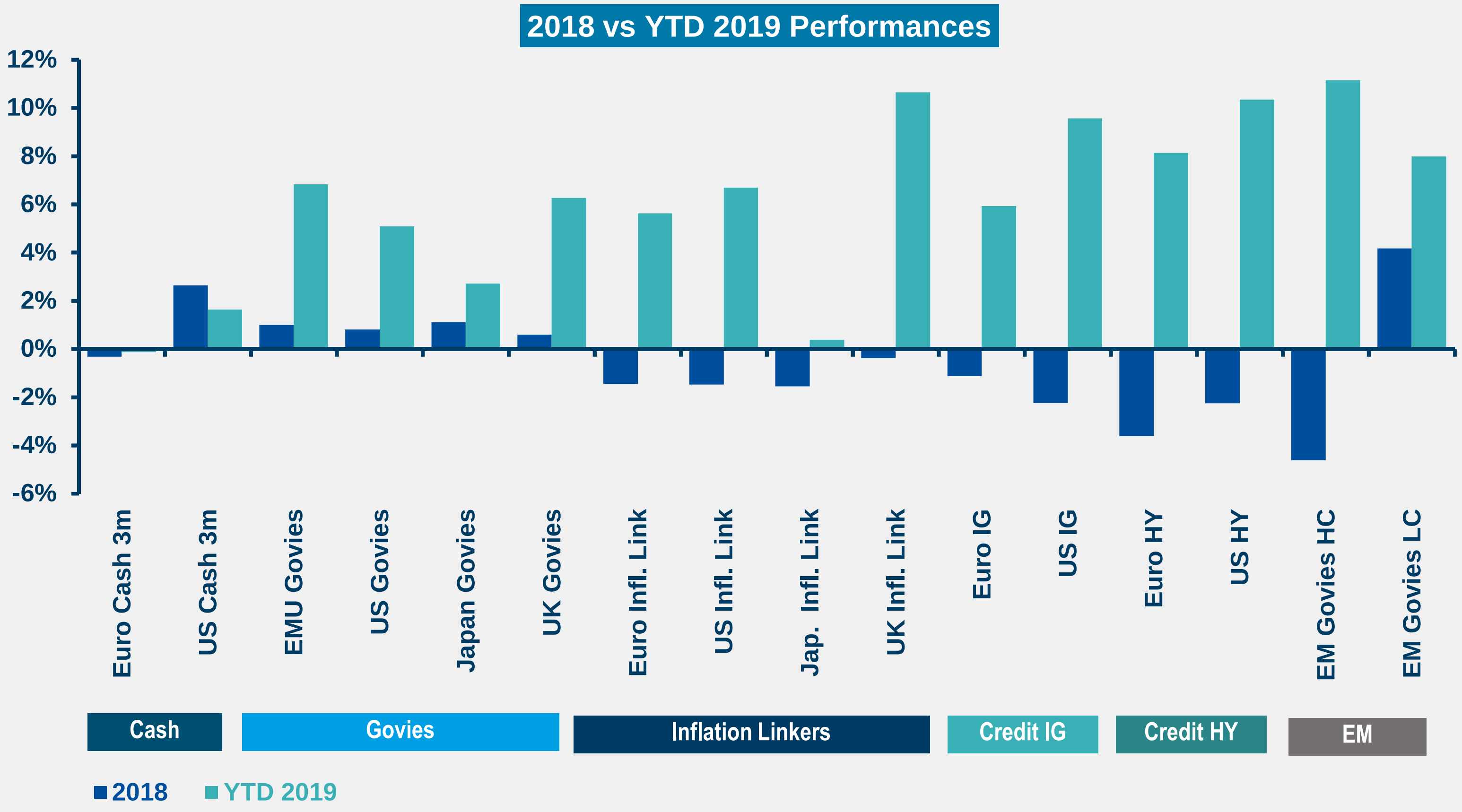
Fixed income markets in 2019



Source: Bloomberg, Amundi. Data as of 17 July 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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Macro themes

Key macro themes

KEY THEMES

GROWTH: DOWNSIDE RISKS, NO RECESSION IN 12 MONTHS

Economic slowdown continued in Q2, and quality of growth deteriorated (weaker investments, trade). CB "insurance policy", fiscal/monetary expansion and trade truce could help the economy to stabilize

CENTRAL BANKS "BAZOOKA" READY AGAIN

CBs have returned to accommodative monetary policies. Reactive fine-tuning in speed and magnitude

DOMINANCE OF POLITICS SET TO REMAIN

Some recent improvement (Italy, EU appointments, trade talks), but the list of risks is still long: China - US, Iran, Brexit, interference in CB policy

LONG-TERM FOCUS

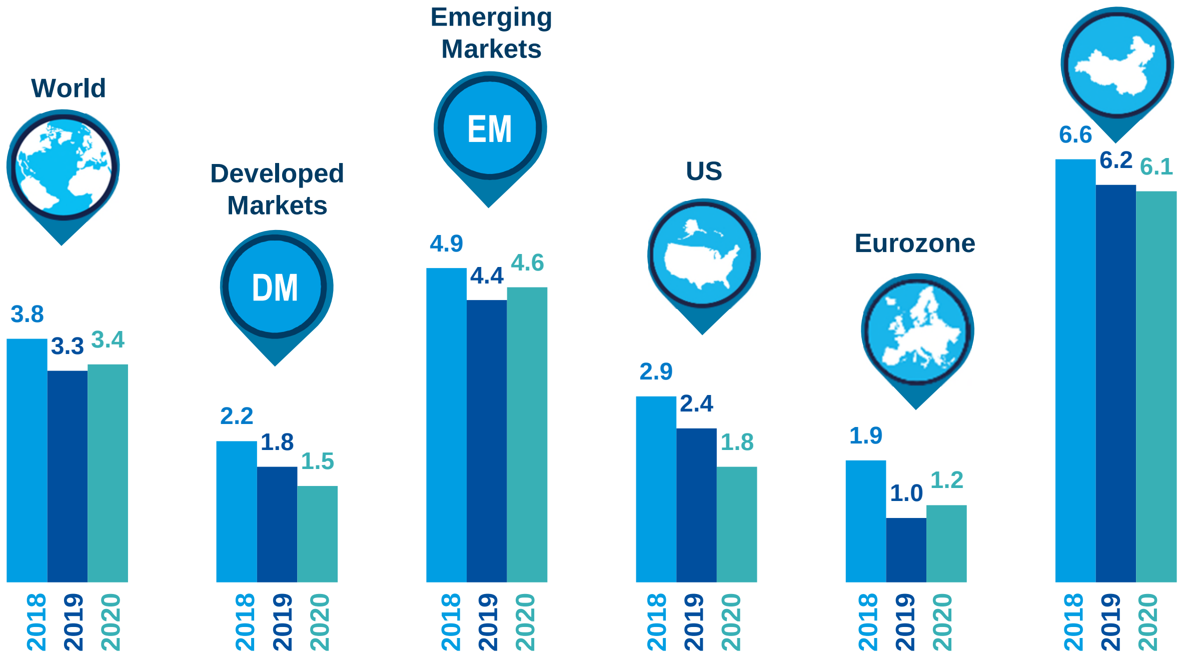
GLOBAL TRADE, DEBT, CLIMATE CHANGE

Some challenges have to be monitored in the long term: global trade retreat, high/growing debt, climate change risk

Source: Amundi, as of 23 July 2019.

Economic deceleration and low inflation

World GDP annual average growth rate, YoY average, %



Inflation CPI, YoY

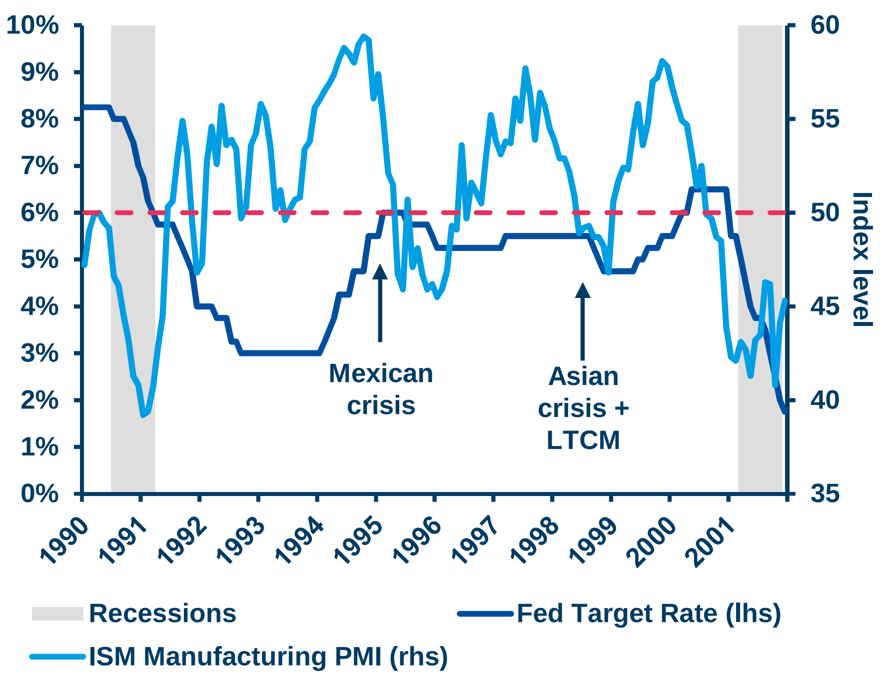
	2018	2019	2020
DM Developed Markets	2.0%	1.6%	1.8%
EM Emerging Markets	4.0%	3.9%	3.8%
World	3.2%	3.0%	3.0%

» Global growth is projected to slow down to 3.3% in 2019. Domestic demand is a key driver of growth while the external component, due to tariff increases, and the manufacturing sector are the weakest spots.
According to our forecasts, the US economy should also decelerate in 2020 while there could be a slight reacceleration of growth in both EM and Europe moving towards 2020.

Source: Bloomberg, Amundi Research. Data as of 23 July 2019.

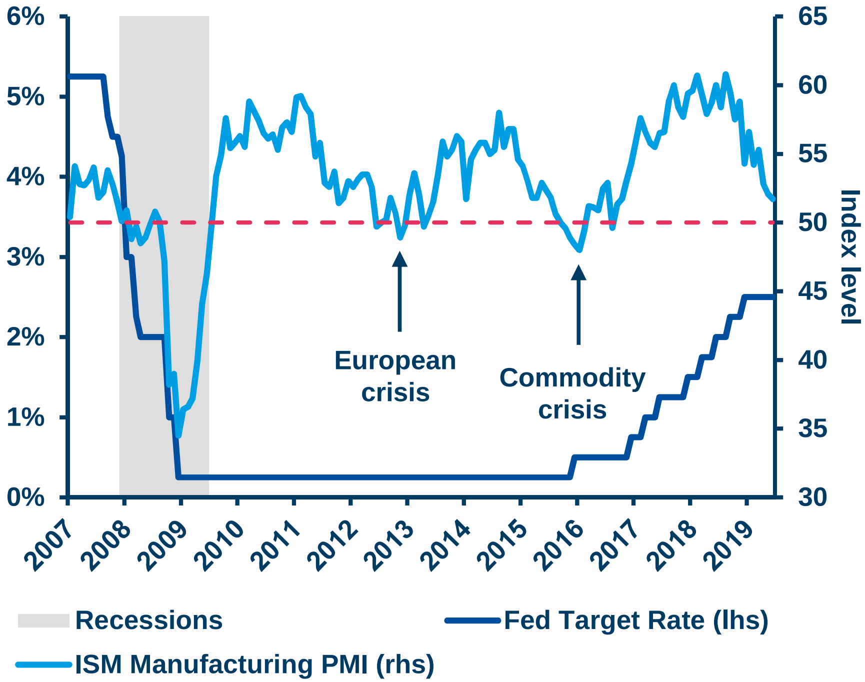
A “pre-emptive” FED to prolong the cycle

ISM Manufacturing and the Fed in the '90s



Source: Bloomberg, Amundi Research. Data as of 23 July 2019.

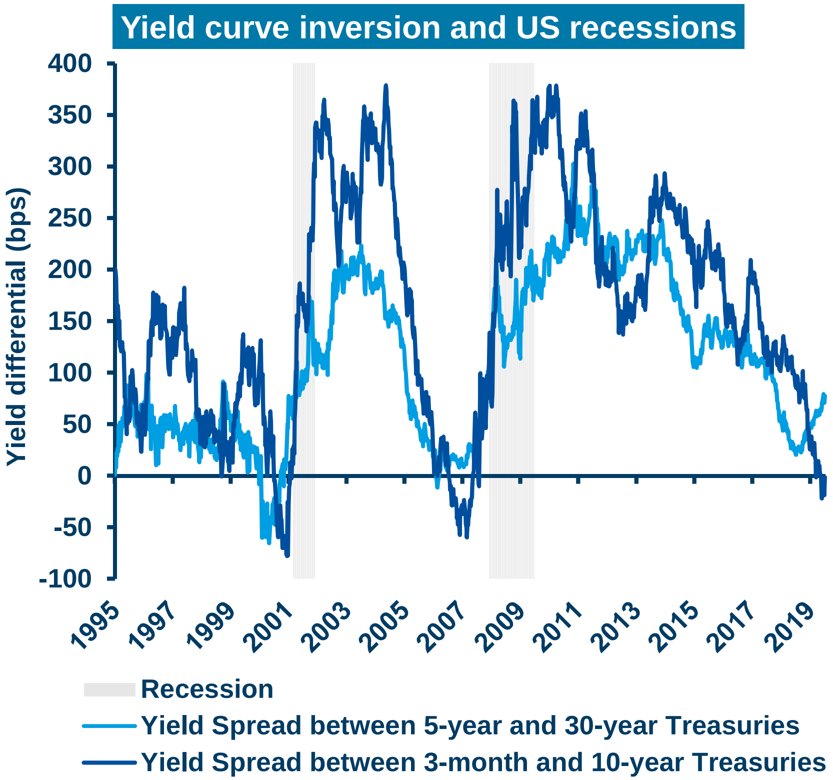
ISM Manufacturing and the Fed since 2007

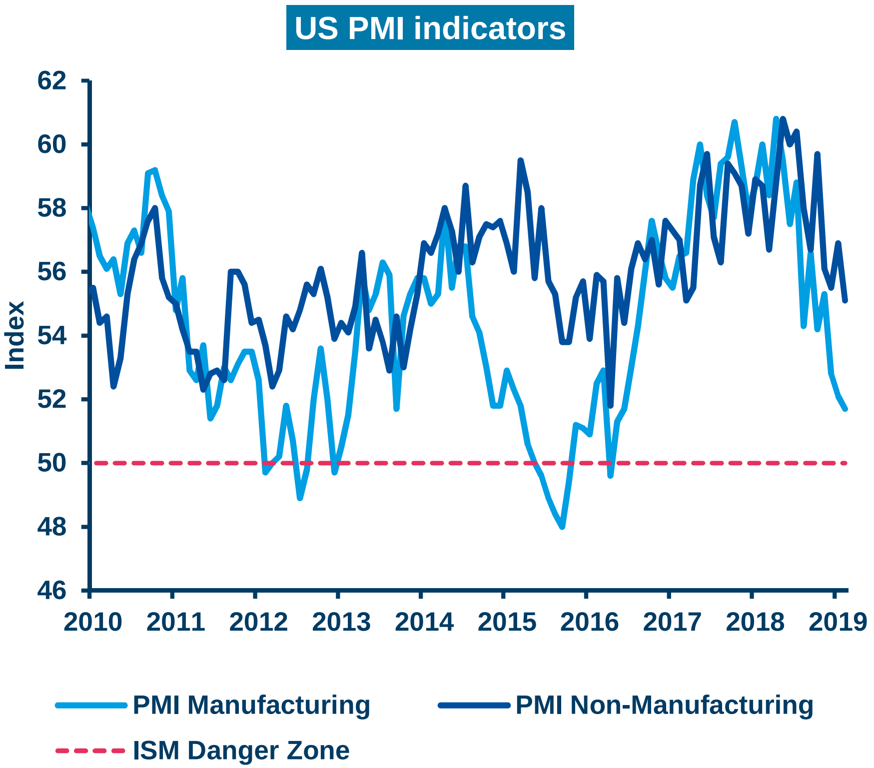


Source: Bloomberg, Amundi Research. Data as of 23 July 2019.

» manufacturing recession does not always mean a general recession. In the mid-1990s and in 1998, the Fed cut rates by 75 bps (as ISM was < 50) and eventually prolonged the cycle. Today, the yield curve has inversed, which means that the neutral rate has probably been reached. Given the deflationary risk (a big difference vs the 1990s), the Fed has decided to act in a more preventive manner.

Looking at the yield curve and PMI indicators



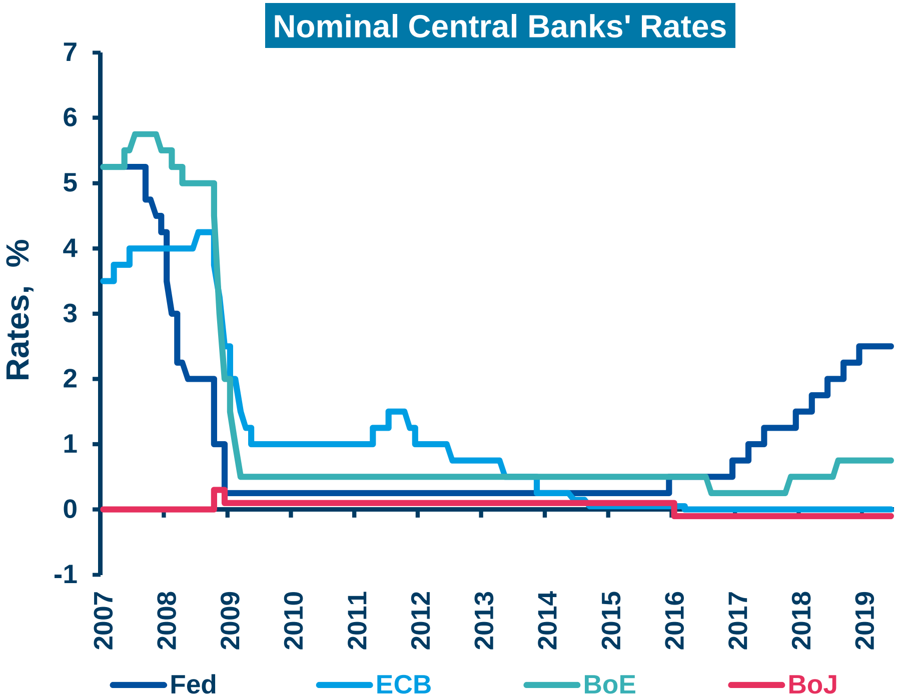


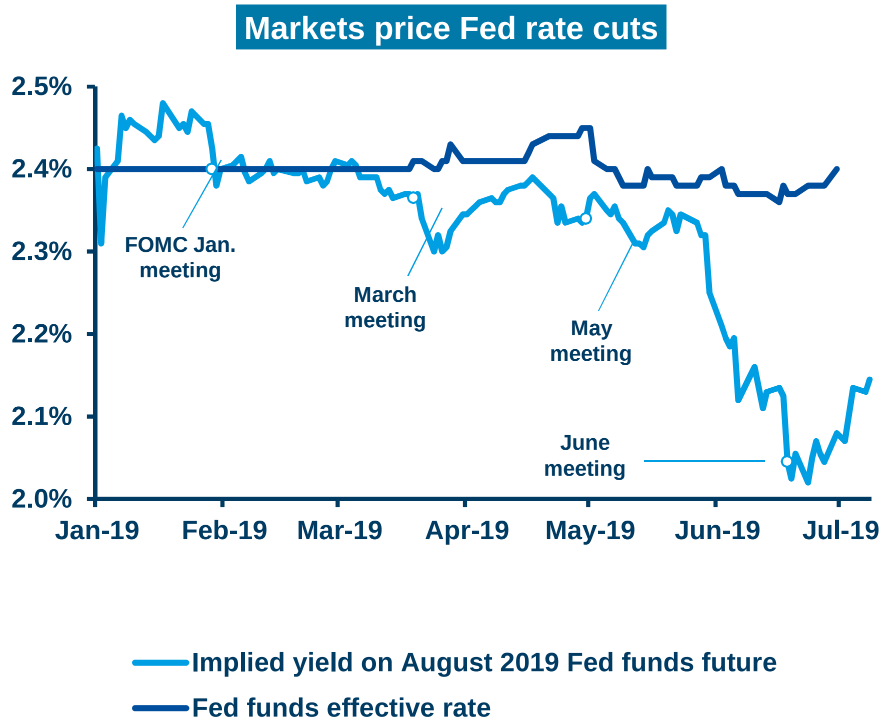
» Rising concerns over the US economic outlook, mainly due to the weakening manufacturing sector, have pushed the yield differentials between three-month and 10-year yields below zero for the first time since 2007 – in a pattern that in the past had anticipated future recessions.

Source: Bloomberg, Amundi. Data as of 12 July 2019.

Source: Bloomberg, Amundi. Data as of 12 July 2019.

Central Banks dovish across the board

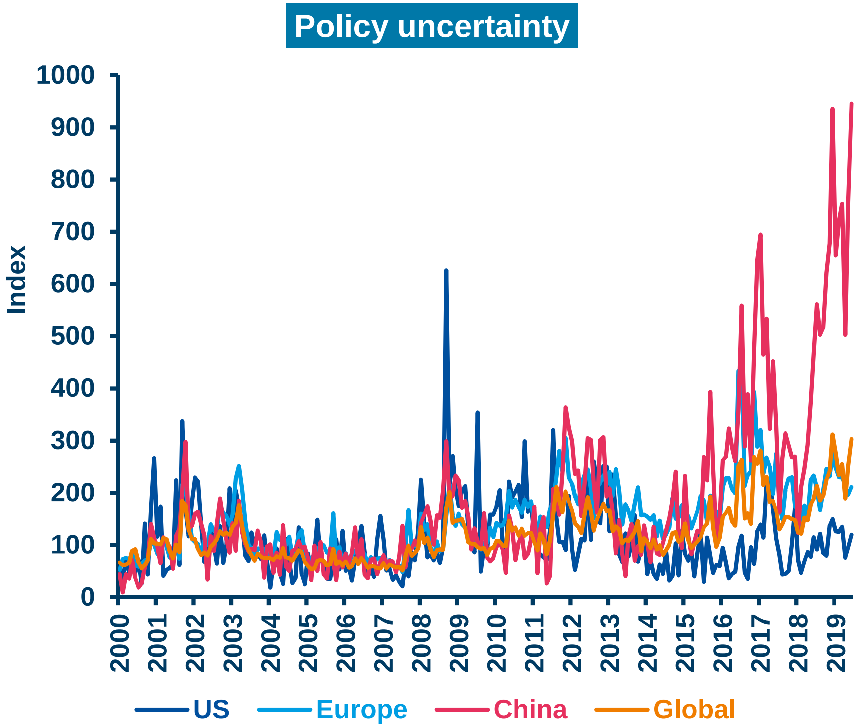


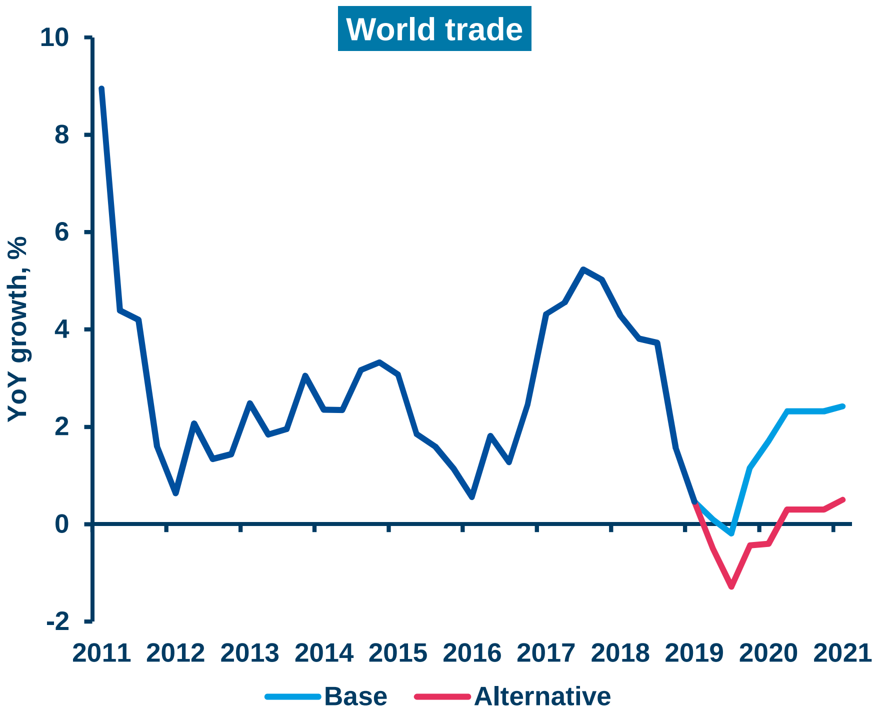


Fed Becoming even more dovish. We expect the 50bps of rate cuts by the end of 2019.
ECB More easing to come. Reopening of QE (CSPP) and further rate cuts in case of "adverse contingencies".
BoE Chances of a rate cut occurring have increased, Brexit still an open question
BoJ Easy monetary policy to be continued at least until 2020. A more accommodative stance in case of need.
EM Central Banks: Softer stances from most EM central banks, given more benign inflation expectations and DM CB accommodative stances.

Source: Bloomberg, Amundi. Data as of 7 July 2019. US Fed: Federal Reserve; ECB: European Central Bank; BoE: Bank of England; BoJ: Bank of Japan.

The dominance of politics: protectionism in the spotlight



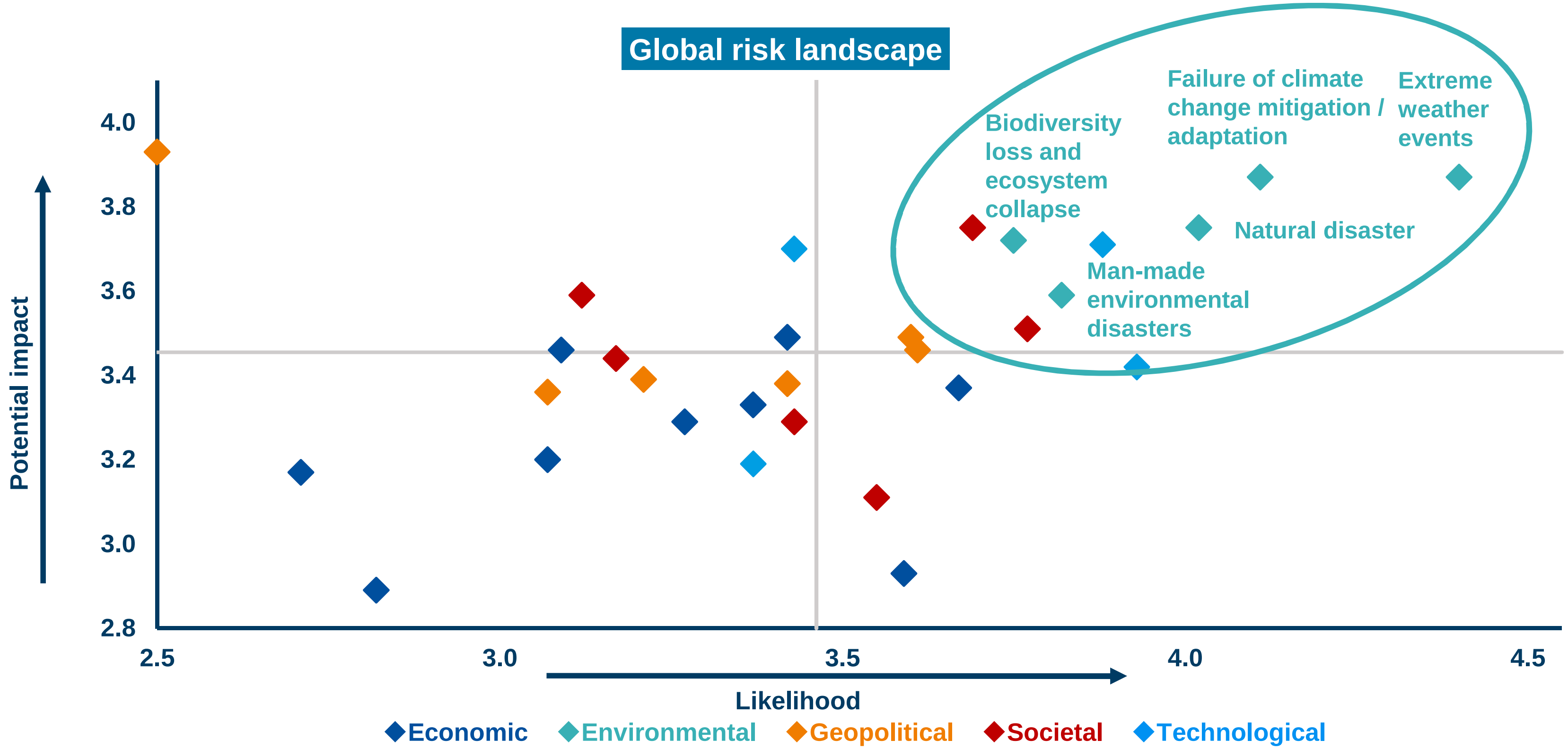


» Global policy uncertainty increased overall in June, notwithstanding the US-China trade truce at the G-20 meeting. Global trade disputes, tensions in the Middle East, Brexit and European fragmentation remain in the spotlight. The most recent data are flagging that China policy support is beginning to take effect while trade disputes risk weigh on global trade.

Sources: Baker, Bloom & Davis, Amundi. Data available as of 07 July 2019. Policy uncertainty indicators based on archives from Access World New's NewsBank.

Source: CPB World Trade Monitor, Amundi. Data available as of 30 June 2019.

Climate issues are perceived as major LT risks



For the next 10 years, climate and societal-related risks are among the top key concerns for investors.

Source: World Economic Forum Global Risks Perception Survey 2018–2019. Global Risks Perceptions survey is completed by around 1,000 members of WEF multi-stakeholder communities. Note: Survey respondents were asked to assess the likelihood of the individual global risk on a scale of 1 to 5, with 1 representing a risk that is very unlikely to happen and 5 a risk that is very likely to occur. Survey respondents also assessed the impact on each global risk on a scale of 1 to 5 (1: minimal impact, 2: minor impact, 3: moderate impact, 4: severe impact and 5: catastrophic impact).

Fixed income investor needs

Fixed income investor needs

Search for yield, flexibility/diversification and ESG at the forefront

Market themes and implications

Core bond yields	Credit spread levels	Interest rates dynamics	To face late cycle and long-term risks
NEUTRAL	SLIGHTLY POSITIVE	FLEXIBLE	SELECTIVE

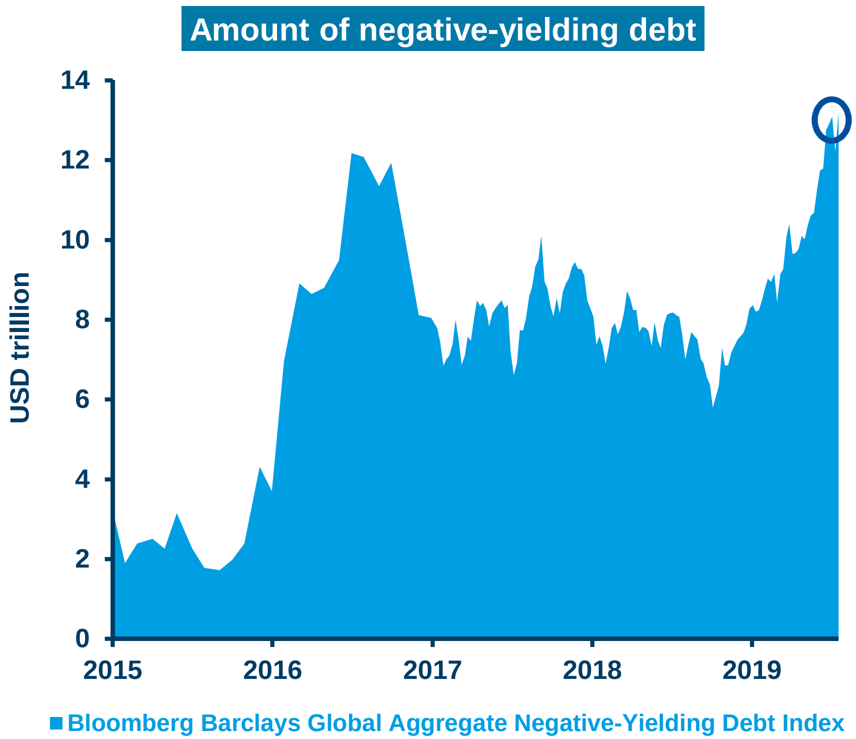
Search for yield

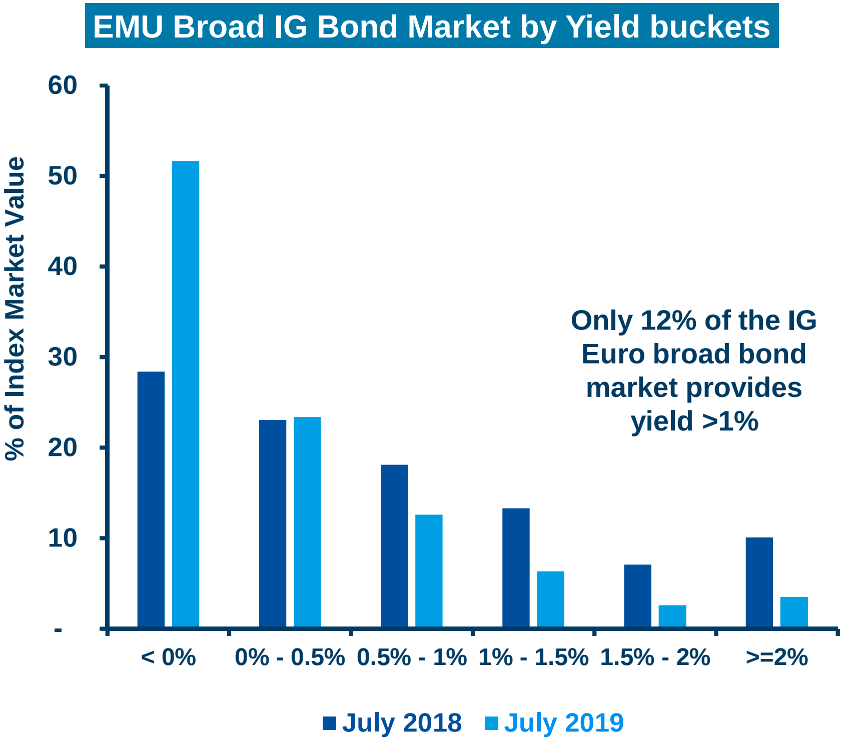
Diversification and flexibility

ESG & climate change

Source: Amundi. Data as of 23 July 2019.

The search for yield is well alive





» With an uncertain economic outlook, high geopolitical risk and more dovish Central Banks, the amount of negative yielding bonds globally has reached a new record high (above USD 13Trillions). Hence, the search for yield continues to be a key theme for investors, especially in Europe where the yield levels remain subdued.

Source: Bloomberg, Amundi. Data as of 23 July 2019.

Source: Bloomberg, Amundi. Data as of 19 July 2019. Anallysis based on the composition of the ICE BofAML Euro Broad Market Index.

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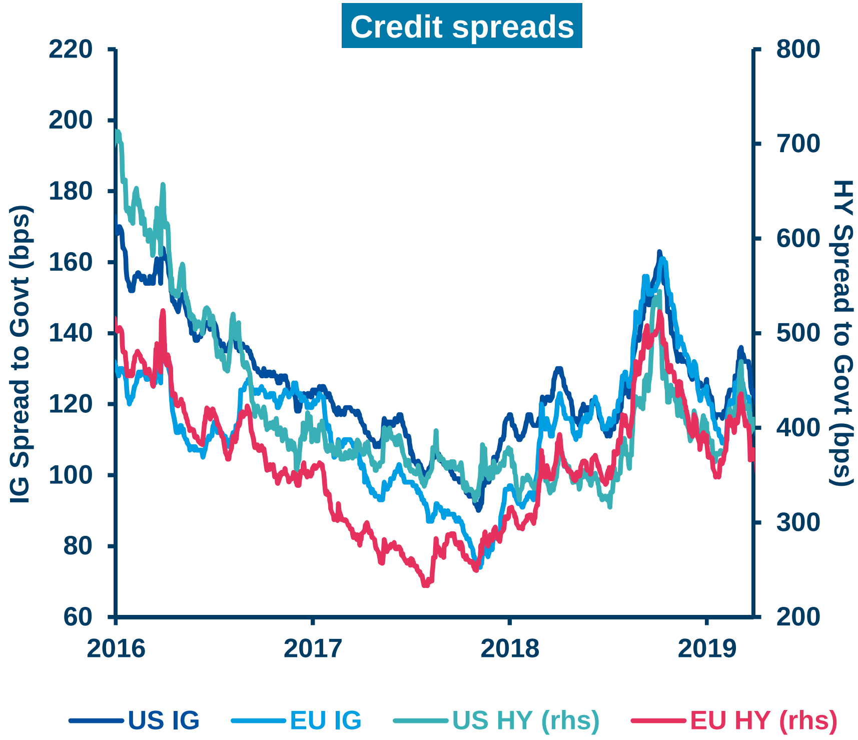
Global credit opportunities in the search for yield



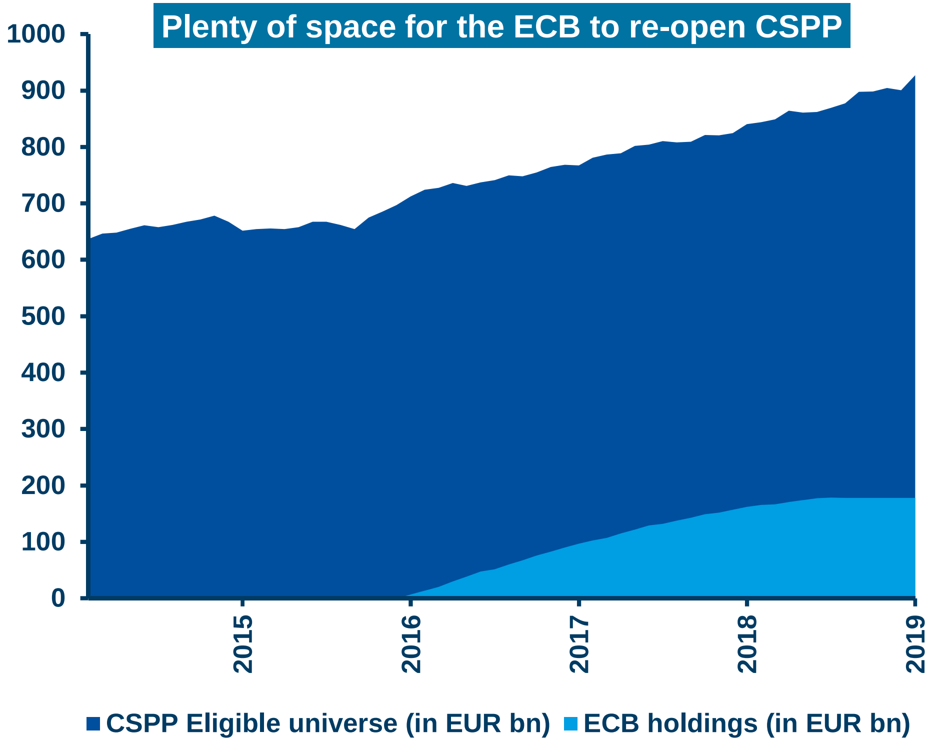
	US IG	Euro IG	US HY	Euro HY
Macro	=	=	=	=
Monetary policy	++	++	++	++
Fundamentals	=	=/+	=	=
Technicals	=	++	=	+
Valuations	−/=	=/+	−	=

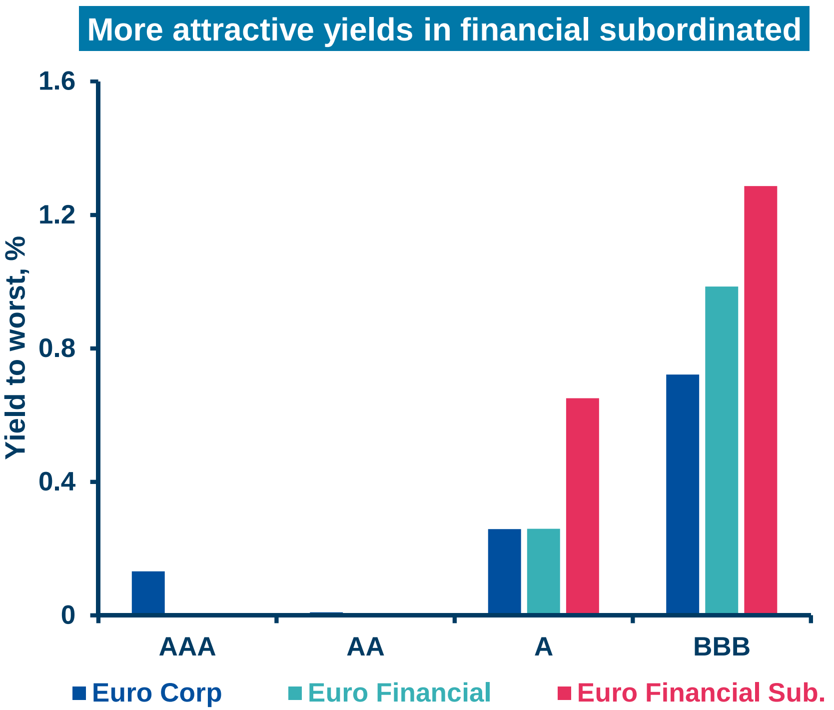
» Global credit markets still look to be an appealing source of carry, as we see some possible spread tightening thanks to more supportive CB policies. Fundamentals and technicals are also supportive for Euro credit, both IG and HY.

Source: Bloomberg, Amundi. Data as of 10 July 2019.

Source: Amundi Research and Amundi Alpha Fixed Income Platform. Data as of 23 July 2019.

IG credit: Euro credit supported by CSPP





» Investment-grade credit remains an attractive asset class for carry reasons, especially in Europe, where the sector could further benefit from supportive ECB policy (ie, CSPP). The ECB holds EUR 177bn of corporate bonds, close to 20% of the eligible universe. Investors could exploit selective opportunities at the sub-sector levels as well: for instance, in Euro subordinated financials offering attractive yields.

Source: Bloomberg, Amundi Research. Data as of 10 July 2019. CSPP=Corporate sector purchasing programme.

Source: Bloomberg, Amundi. Data as of 18 July 2019. ICE BofAML Indices.

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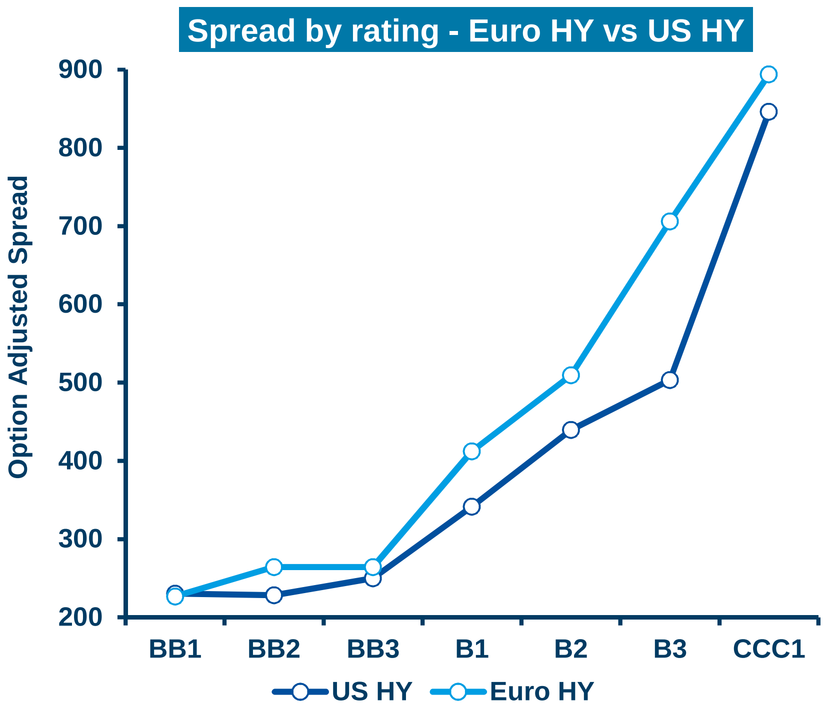
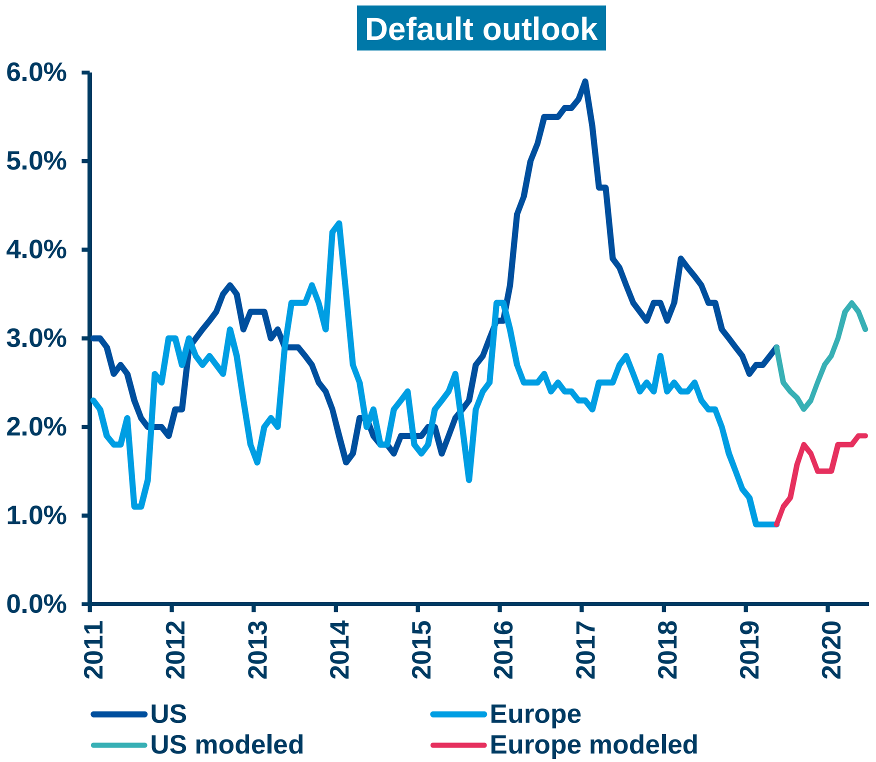
HY credit: benign default outlook, but be selective





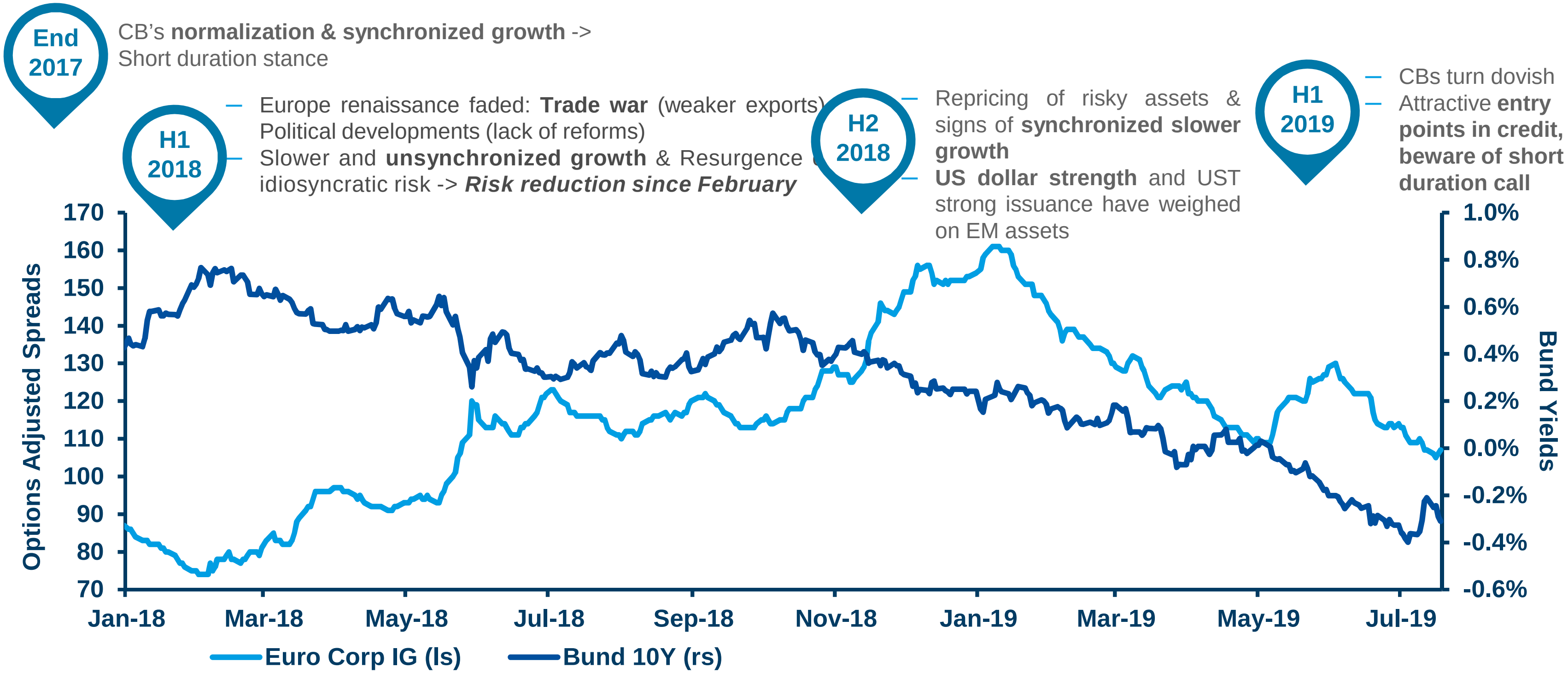
The default outlook for the high-yield market is still benign, with only mild increases likely in the next 12 months. Some caution is warranted in the highly indebted segments amid a global economic slowdown. Euro HY is better positioned than the US market in terms of yield and default outlook. Focus on selection and careful liquidity management.

Source: Bloomberg, Amundi. Data as of 11 July 2019.

Source: Moody's, elaboration by Amundi Research. As of 11 July 2019.

Flexibility is key in a late phase of the cycle

Time to actively rotate risk in the euro aggregate universe



As the cycle ages, the market starts to increase the probability of a future recession, with a concomitant negative impact on market sentiment. Although we believe there is still room for risky assets (credit), we suggest moderation in the deployment of risk budgets, given the price rally early this year and the global risks still on the rise. An active approach is needed to deal with sudden changes in risk sentiment typical of an aging cycle.

Source: Bloomberg, Amundi, as of 18 July 2019.

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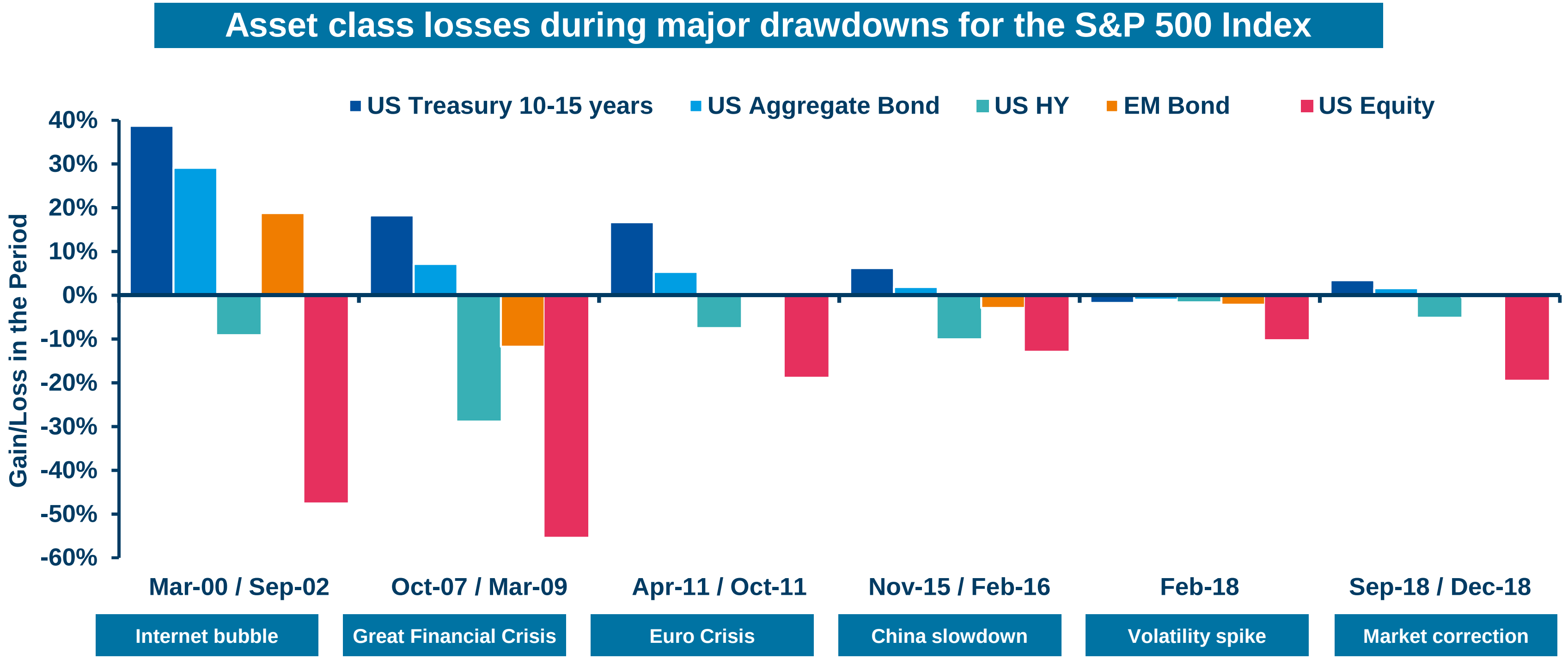
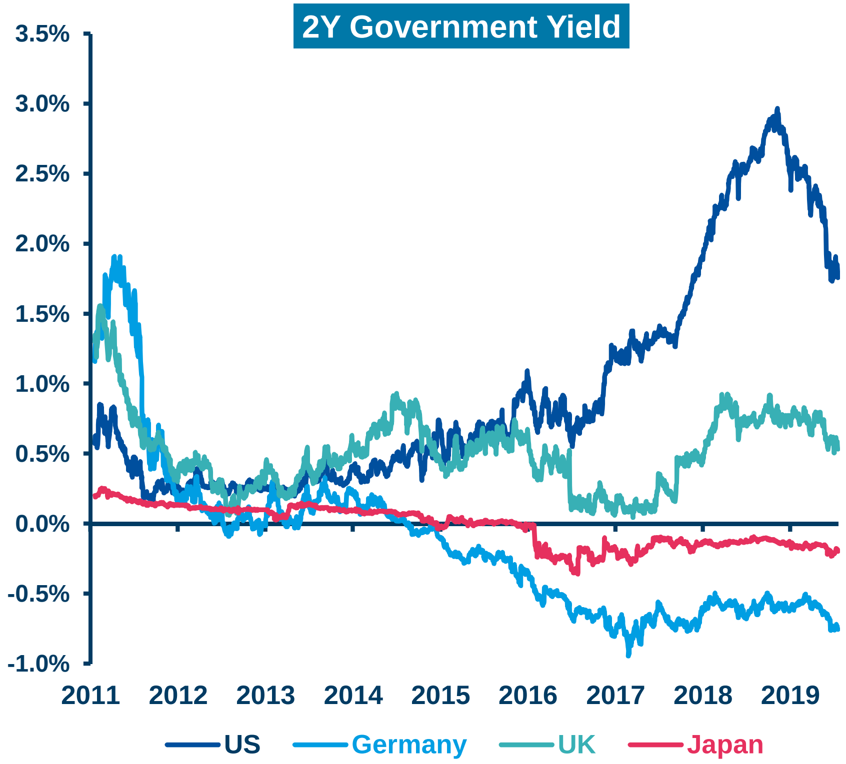
Rethinking core bond allocation as a shock absorber during risk off phases

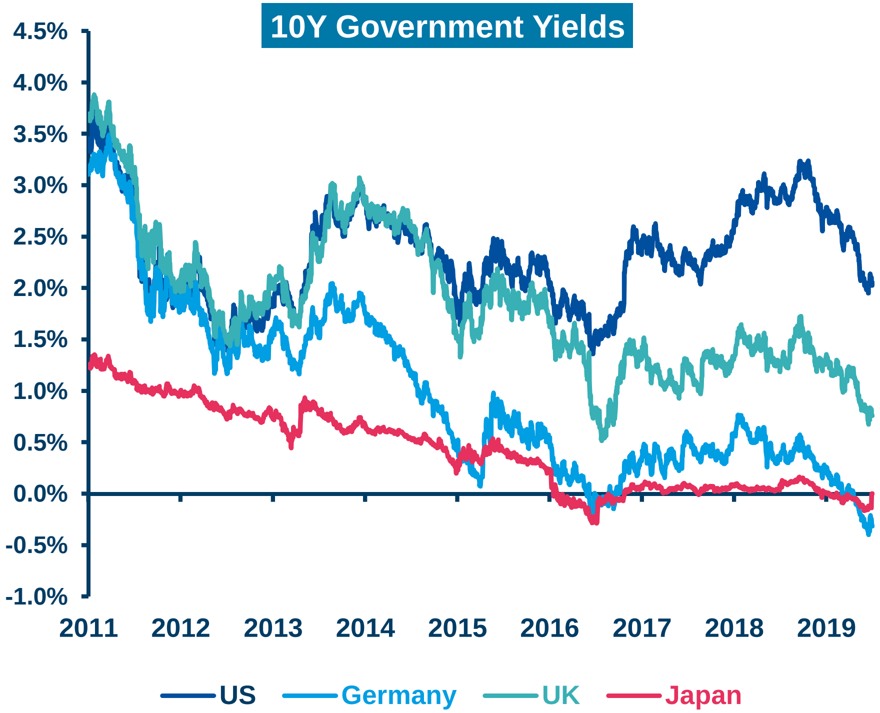


» Investors in search of safe assets are looking at core bonds and high-quality bonds as diversifiers of risk assets during phases of market turmoil. As liquid assets, demand for them will likely continue to be strong.

Source: Bloomberg, Amundi, as of 13 July 2019.

Global bonds: core bond yields falling, play relative value





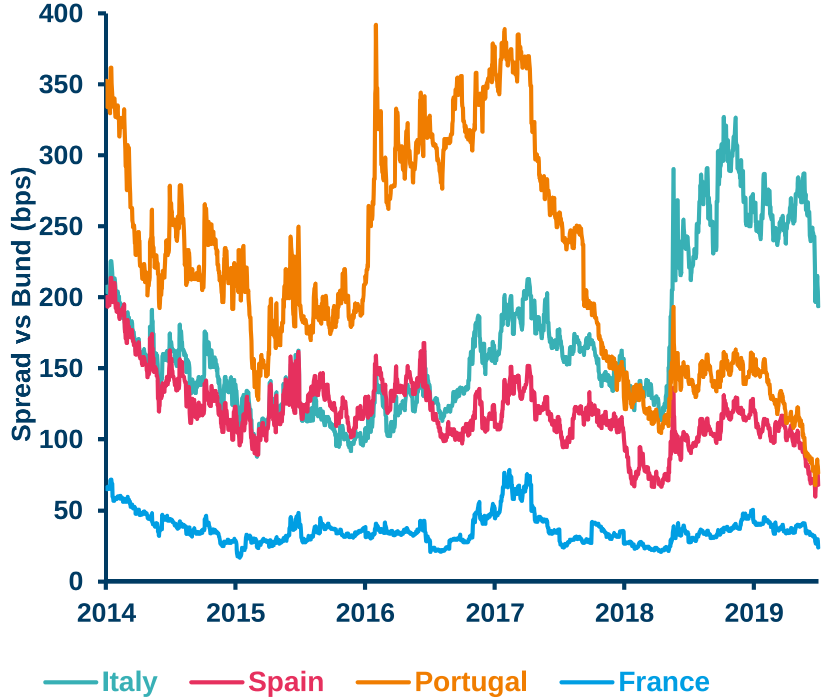
» Government bond yields across the world are falling, as there is strong demand for safe assets and scarce supply. Investors should consider core bonds for liquidity purposes and seek opportunities across the curve (steepening in US and flattening in the Euro curve).

Source: Bloomberg. Data as of 19 July 2019.

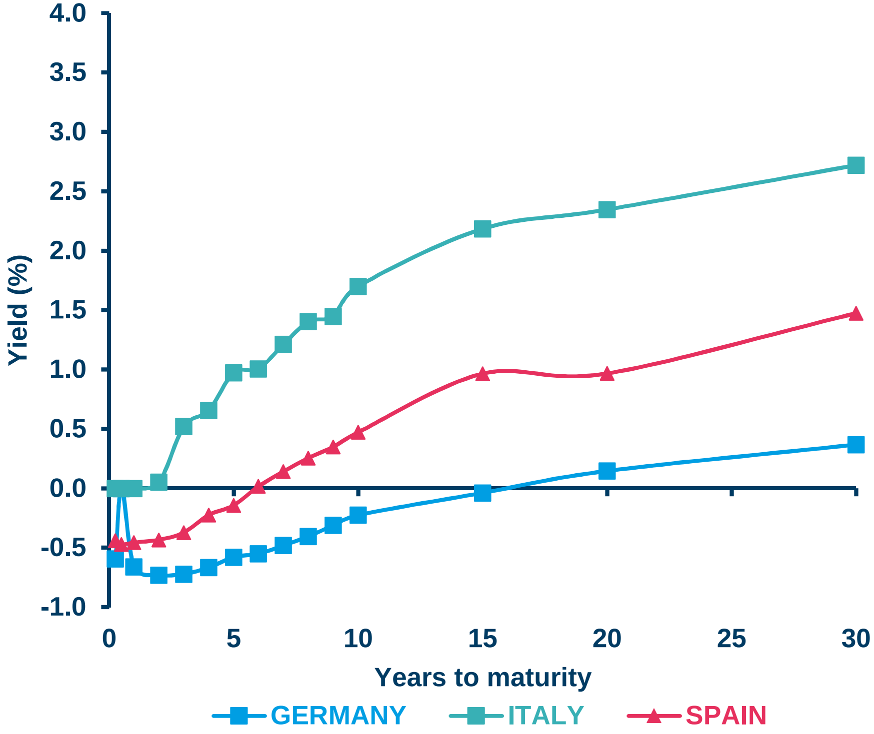
Source: Bloomberg. Data as of 19 July 2019.

Euro bonds: opportunities at curve and country levels

10Y Govt bond spread vs Bund



Yield Curves



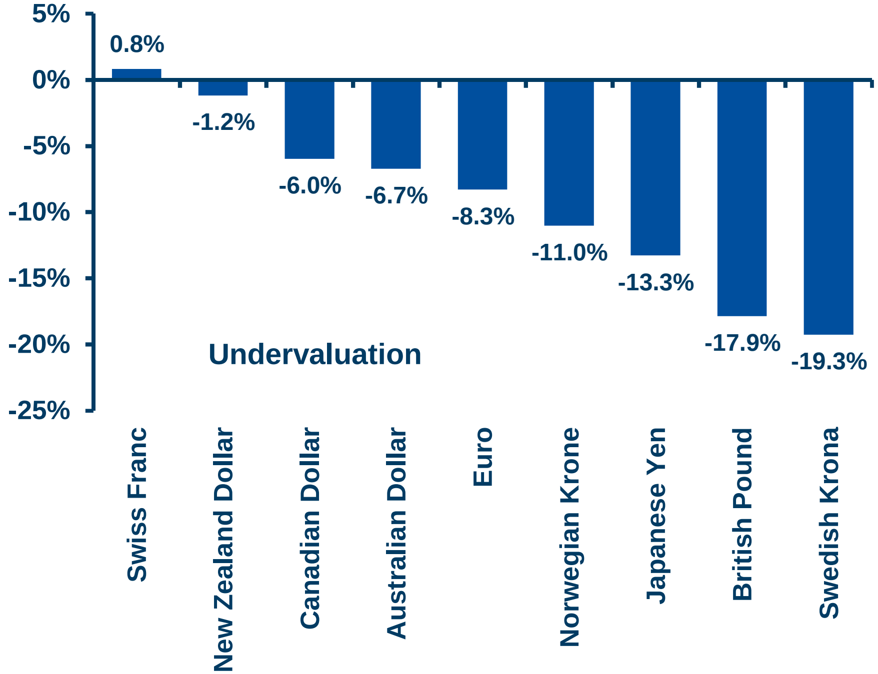
Euro fixed income received strong support from the ECB's new accommodative measures. This should benefit peripheral bond markets, which are favoured in the search for yield. Opportunities in curve appear to be flattening.

Source: Bloomberg, Amundi. Data as of 10 July 2019.

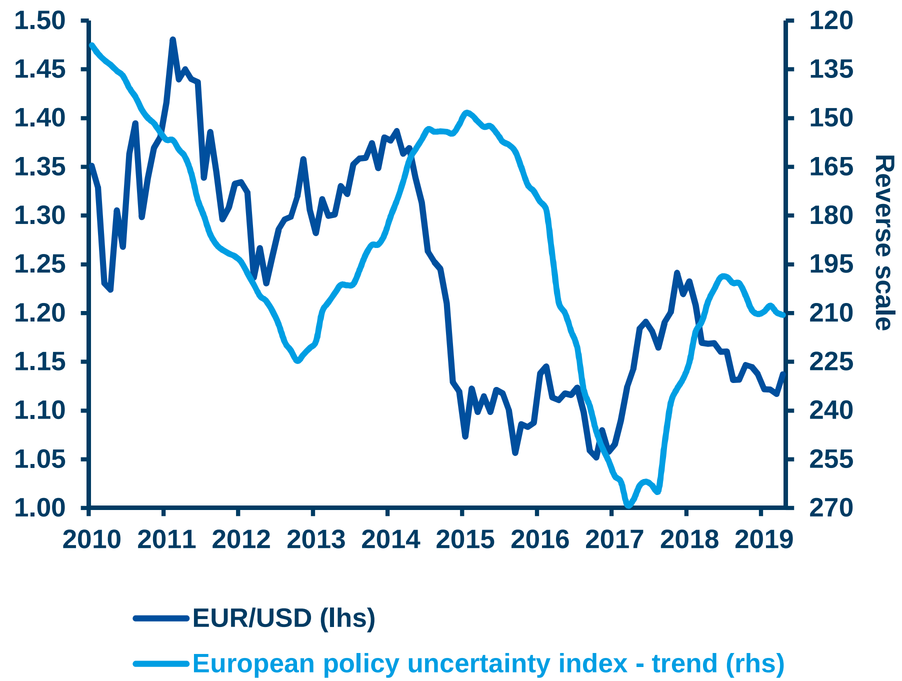
Source: Bloomberg, Amundi. Data as of 10 July 2019.

Currencies: an area in which active investors can further diversify

G10 FX over/under valuations vs USD



EUR/USD and political risk

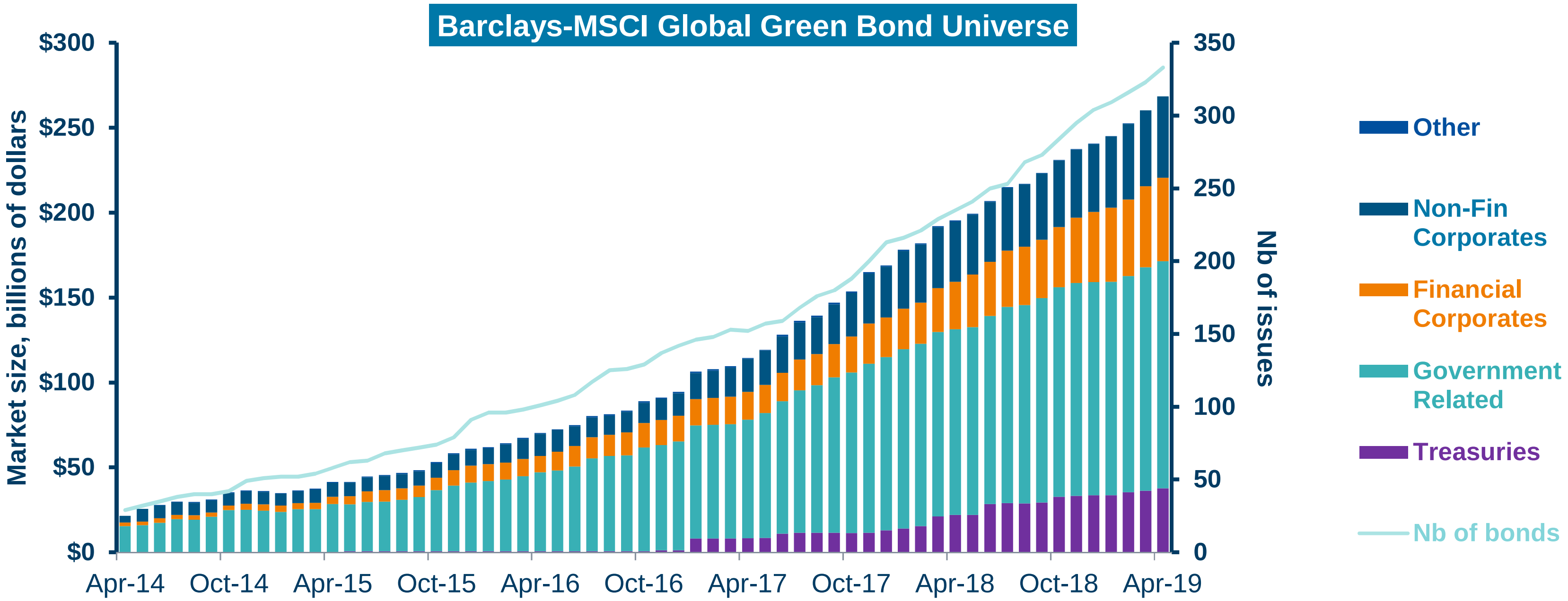


» Political uncertainty in Europe and a dovish ECB tone are keeping downward pressure on the euro. Improving domestic growth as well as a better trade outlook should provide some relief to the European currency. Conversely, the USD is overvalued vs the entire G-10 universe.

Source: Bloomberg Amundi Research. Data as at 11 July 2019. Graphs shows current Over/Under valuations vs mid-term fair values. Fair value calculated as an average of different measures (productivity, Purchasing Power Parity, Real Effective Exchange Rate).

Expanding green bond universe

Growing market offering resulting in increase in diversified opportunity set



» For investors, green bonds offers similar market returns as compared to regular bonds, with higher transparency and a market that now is more developed and diversified. Investors pursuing a sustainable development focus can embrace green bonds as a way to finance Energy Transition projects. Green bonds are also attractive for investors with a 'pure' impact investing strategy.

Source: Amundi and Barclays, as of end of May 2019.

Conclusions

Key Investor needs | **How to play**

Search for Yield

- Explore yield opportunities in global credit markets
- Look beyond traditional market segments: listed vs non-listed and liquid vs illiquid

Flexibility and diversification

- Adopt an unbiased and flexible approach to get the most from aggregate bond markets
- With anchored low yields, consider factor investing and/or rule based strategies to further diversify the alpha sources

ESG & Climate Change

- On-board ESG and climate change in portfolio construction

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5 Mar 19	European elections: five things to know and market implications
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Indexes reference & definition

Fixed Income Market Indexes (pag. 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 BofAML US High Yield; EM Govies HC = JPMorgan EMBI Global Composite; EM Govies LC = J.P. Morgan GBI-EM Global Composite LOC.

Definitions

- **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).
- **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.
- **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.
- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **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.
- **Alpha** measures risk-adjusted performance, representing excess return relative to the return of the benchmark. A positive alpha suggests risk-adjusted value added by the manager versus the index.

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