

Rethinking fixed income investing when the easy money is coming to an end



Eric BRARD
Head of Fixed Income



Laurent CROSNIER
CIO London
Head of Global Fixed Income



Myles BRADSHAW
Head of Global Aggregate

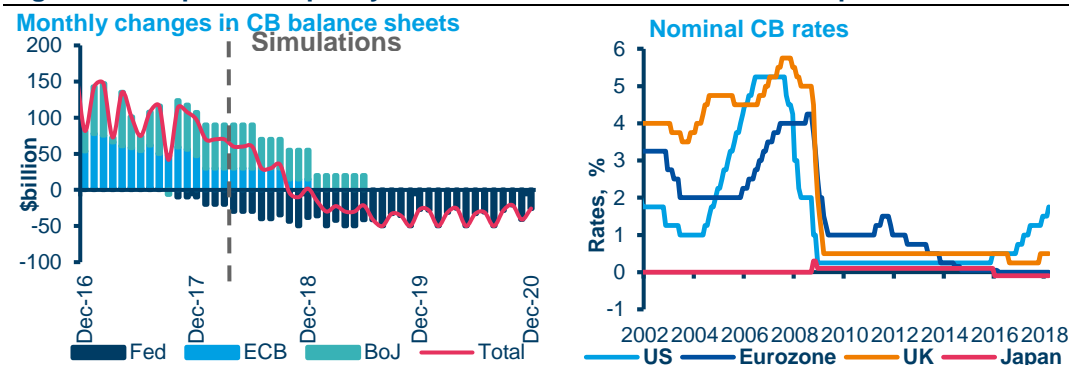
- **The era of easy money is coming to an end:** A strong economic backdrop is leading central banks to remove excessive monetary policy accommodation, at different speeds. The peak of liquidity looks to be behind us and this new environment may point to different market scenarios.
- **Time to rethink fixed income investing:** Fixed income allocation remains key to diversifying the overall risk exposure of a balanced portfolio, especially at a time of rising market volatility. Five themes will, in our view, provide the tools for active bond investors to dynamically exploit opportunities in multiple sectors.
- **Embrace a global diversified approach as part of core fixed income allocation:** A global approach may help investors to expand their opportunity set in search for alpha.
- **Complement the core fixed income allocation with goal-specific solutions:** In a world in which a one-size-fits-all approach is no longer suitable, investors should build a core bond allocation based on their specific needs based on a diversified approach utilising active solutions to target specific objectives.

The end of easy money may point to different investment scenarios

Core fixed income allocation, usually comprising high-quality government and corporate bonds, has played a relevant role in diversified portfolios over the last few decades. In a 30-year bull market for bonds, this allocation has been a stable source of performance; it has, for a long time, provided attractive income and helped to limit the overall portfolio drawdowns. Investors now stand at a crossroads: changes in CB monetary stances are resulting in the end of the easy money era driven by excess market liquidity. While fixed income allocation remains key to diversifying overall risk exposure in a balanced portfolio, especially at a time of rising market volatility, we believe it is time for investors to rethink their investment approaches in order to deal with the possible scenarios ahead.

In a stronger growth environment, our base case is for a gradual rise in interest rates, which is healthy at this stage. We see at least two further Fed rate hikes in 2018, with the possibility of seeing more with pressure building on inflation. The European Central Bank, while keeping a more accommodative stance, will wind down the Public Sector Purchase Programme (PSPP) in 4Q18. The Bank of Japan will likely lift the 10Y target, proportional to the global yields level, and the unwinding of the negative interest rate policy could follow very closely. The Bank of England appears likely to raise rates once in 2018, as a consequence of higher inflation. This means that the peak of liquidity is behind us.

Figure 1: The peak of liquidity looks to be behind us: different CB policies



Source: Amundi Research analysis on Bloomberg data. Data as of 30 March 2018.

“In our base scenario, we expect a gradual rise in interest rates - with CBs acting at different speeds - low default rates and little room for further spreads tightening in credit”.

“Investors should be aware that alternative scenarios, such as a boom and bust as an extension of the US business cycle, could drive different dynamics in fixed income markets”.

Regarding fixed income markets, this also means a challenging environment for core govies, but, as a consequence of a strong growth outlook, a still-constructive outlook for credit. However, CB will not act in a synchronous manner, as economies are at different stages in the cycle: this implies different speeds in adjustment in rates (with European govies more vulnerable than US govies, where a repricing has already started). As to credit, different levels of corporate leverage (with the US more leveraged than Europe) has to be considered in a backdrop of tight credit spreads. This implies that selection at the sector/company level will become increasingly important. Investors should also consider that two alternative scenarios may emerge: the extension of the US business cycle, thanks to the fiscal boost (more inclusive growth, no inflation spike), could continue to benefit the credit market and drive a smooth path of rising long-term rates; on the other hand, an acceleration of inflation, due to an overheating economy or as a consequence of raising geopolitical risk (trade tariffs, oil price spike), could lead to a more aggressive Fed reaction. This could trigger a risk-off phase, penalising over-indebt companies and putting US government bonds (especially short-term maturities) under severe pressure. As we move towards a more uncertain scenario, in which CB take different normalisation paths and markets more carefully assess inflation and growth dynamics in the search for a confirmation of their base scenarios, we believe that investors should rethink fixed income investment approaches. A first step would be to gain an understanding of the challenges and opportunities ahead given that bond markets have experienced a profound transformation. This will enable investors to uncover approaches that would best address the new investment landscape in line with their specific objectives.

“Building a resilient core bond allocation to navigate the possible scenarios ahead will be about exploiting multiple alpha sources and turning potential challenges into opportunities”.

Challenges for some can be opportunities for others

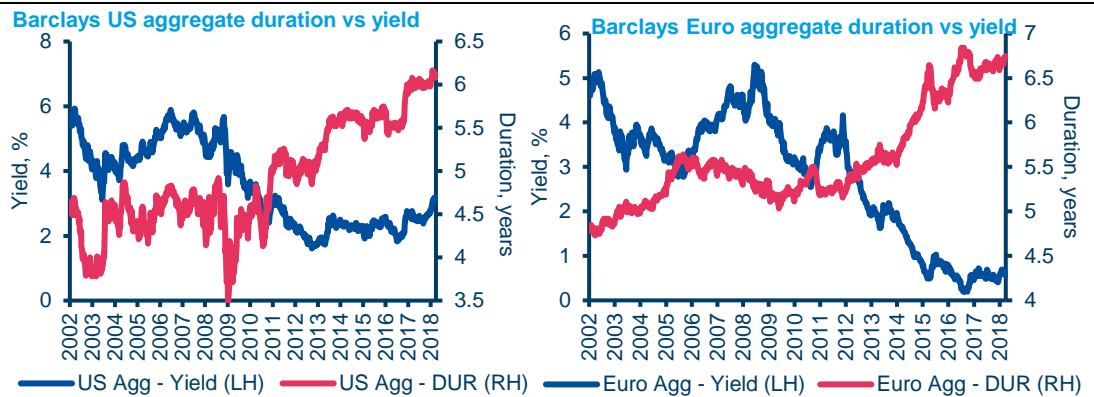
With the end of easy money, we believe that more traditional static allocation approaches that have benefitted from a long period of decline in bond yields will be called into question. While the maths of bonds implies that these assets will be negatively affected in a rising rate and rising yield environment, the impacts could vary widely across sectors and markets, and very much depend on the pace of the hiking cycle. We believe that building a resilient core bond allocation in order to navigate the possible scenarios ahead will be about exploiting multiple *alpha*¹ sources and turning potential challenges into opportunities.

To do this, investors will need to assess the following five key investment themes:



- 1. The end of easy money:** as we have pointed out, this will open different scenarios and will have different implications across markets. Active investors could play yield differentials, as well as moves in yield curves and currency rates, driven by the end of easy money and CB actions.
- 2. Deal with rising interest rates:** tactical duration management and relative value strategies, within and across yield curves, will be more relevant as interest rate risk rises and market duration stands at historical highs.

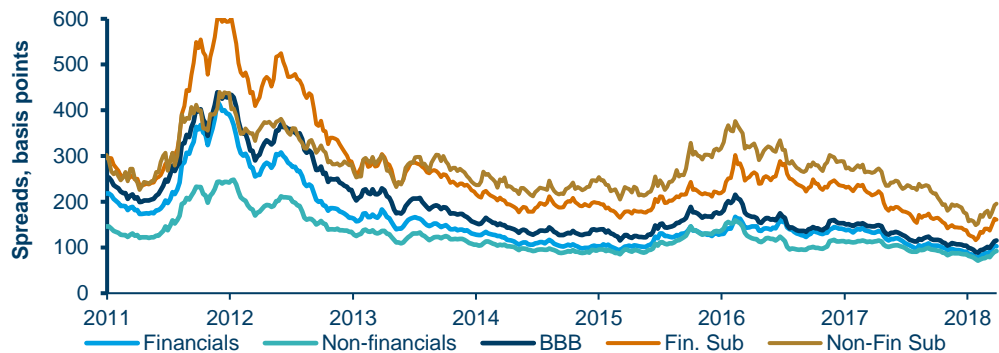
¹Alpha: The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager vs the index. Beta: The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager versus the index.

Figure 2: Yields and duration in the Barclays US and Euro Aggregate indices

Source: Amundi analysis on Bloomberg data. Data Refers to Bloomberg Barclays Euro and US Aggregate Bond Index, as of 30 March 2018. 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.

“Selection in credit markets will be key, as spreads are quite tight across the board. In our view, an area of current opportunity is European financials”.

3. **Get the most from mature credit markets:** Corporate bond selection will make a difference, as conditions in credit markets are becoming more mature, with spreads already quite tight across the board. Searching for income across multiple sectors, including emerging markets, with a dynamic approach, will also be key to exploiting yield opportunities in a rising rate environment. Within developed markets, our preference is for European financials. Valuations are relatively attractive and credit quality is likely to improve as a strengthening economy lifts loan growth and net interest margins, and reduces non-performing loans.

Figure 2: Euro credit spreads

Source: Amundi analysis on Bloomberg. Data as at 30 March 2018. Indexes ICE BofA Merrill Lynch (EB00, EN00, ER40, EBSL, ENSU).

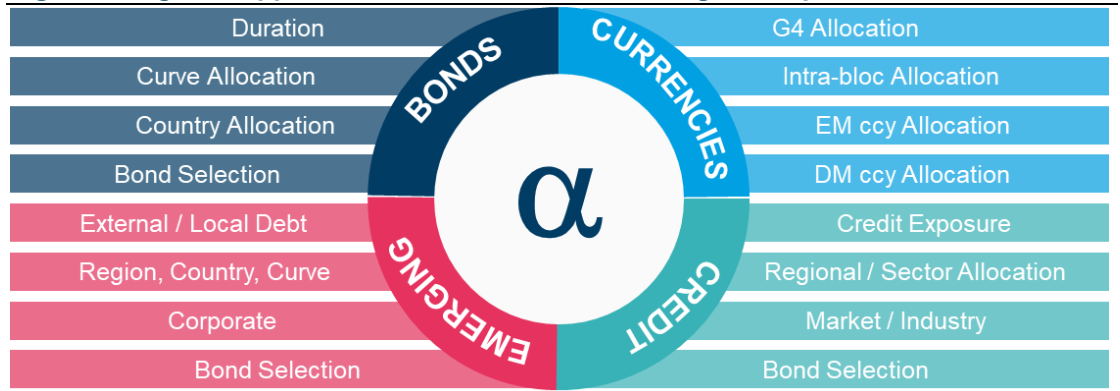
4. **Focus on managing liquidity risk:** Liquidity risk management should be at the forefront of investor priorities in the new investment landscape. In fact, this risk could re-emerge with worsening liquidity conditions in the market amidst CB balance sheet reduction. Being able to play opportunities across the liquidity continuum, while maintaining sufficient liquidity buffers, by tactically allocating to government bonds for liquidity purposes or focusing on liquid strategies will be key, in our view.
5. **Seek additional sources of diversification:** Reducing concentration risk, by introducing new market segments, is a sensible approach, in our view. In this respect, currency dynamics can be relevant as an additional source of returns, showing low correlation with traditional asset classes, and as a variable to consider when investing in global markets. At the same time, widening the focus on the potential spectrum of opportunities (including, for example, the growing private debt market in Europe) can provide additional sources of return with low correlation with traditional asset classes.

“A global fixed income approach can be compelling in this environment as it can benefit from a larger opportunity set”.

Exploring opportunities with a global high-quality alpha approach

In our view, a global fixed income approach can be compelling in this environment as it can benefit from a larger opportunity set. A flexible approach is also key to navigating through this wide investment universe. With multiple countries, curves and currencies to assess, a strong understanding of macroeconomic and monetary policy outlooks for each area is key to identifying cross country relative value allocations, curve positioning and currency dynamics. Furthermore, regarding credit and EM bonds, we believe that selection will be increasingly relevant in order to uncover the names and sectors with the most appealing risk/return profiles. This diversified flexible approach can potentially help investors in this new market environment by targeting both relative and total return.

Figure 4: A global approach can benefit from a full range of “alpha” sources



Source: Amundi. For illustrative purposes.

Further enhance the fixed income allocation with dedicated goal-based investments

As we enter this new market environment, it is critically important for investors to reassess the role of their core fixed income allocation and the key objectives that this allocation should accomplish. In a world in which a one-size-fits-all approach is no longer suitable, we think investors should embrace a “new” enhanced core allocation based on the combination of a well-diversified core allocation and dedicated “goal-based core building blocks” (ie, income or diversification).

Examples of goal-based building blocks that could be of interest in this phase include:

- **High quality short duration:** Investors wishing to mitigate volatility in a phase of rising rates could consider diversifying into high-quality short duration strategies.
- **Optimal yield approach:** Investors making a greater emphasis on income generation, but still wanting to mitigate risk due to possible rising rates, could opt to seek the most compelling yield opportunities with a strong focus on capital preservation.
- **Unconstrained/absolute return:** Investors concerned about being too exposed to duration and credit risk moving towards a more uncertain environment could focus on increasing sources of diversification through absolute return investing.

As we move into uncharted waters, where multiple investment scenarios could emerge, we believe that it is time to rethink fixed income allocation and tailor it around the specific risk profiles and goal mixes for individual investors. This allocation could thus be tactically reassessed should market conditions or investor priorities change over time.

“In a world in which a one-size-fits-all approach is no longer suitable, investors should build a core bond allocation based on their specific needs”.

Important Information

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