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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

FED PREPARES FOR BALANCE-SHEET NORMALISATION

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We expect the Fed to hike rates by 25bps in December and to continue raising rates at a gradual pace next year. The path will also depend on fiscal policy.

What are the major take aways from the Federal Open Market Committee?

Didier Borowski: As expected the Fed continued to keep its key rates unchanged yesterday. The FOMC's decision was unanimous, as it continues to see the near-term risks to the economic outlook as roughly balanced. Markets were particularly expecting more clarity on the timing of the balance-sheet normalisation. In fact, the Fed has left the door wide open, merely mentioning that it will take place "relatively soon" (vs. "this year" in the previous statement). This wording presents the possibility that the normalisation process could begin in September.

What is your outlook for US inflation?

Didier Borowski: First of all, let us recall that core inflation has continuously remained below its long-term average since the Great Financial Crisis. Moreover, average inflation over the past 8 years has fallen to its lowest level since the early 1960s. In addition, core inflation has slowed since the start of the year: the core PCE deflator - which is the best gauge to measuring underlying inflation, according to the Fed - slipped back from 1.8% yoy in January and February to 1.4% yoy in May. While we believe this is due to temporary factors, the low level of core inflation in this cycle illustrates that structural supply-side factors are also at play (globalisation, technological progress, etc.).

GDP growth has stabilised around the trend observed over the past 8 years (2%) and unit labour costs are growing at an above-average pace, putting corporate margins under increasing pressure. Even if pricing power has diminished, we maintain our view that core inflation will materialise sooner or later in an economy operating at full employment. In a nutshell, while inflation is likely to remain subdued by historic standards, at current levels, risks are clearly tilted to the upside.

Finally, potential protectionist measures from the Trump administration add to upside risks for inflation, even if these measures are now less probable than in the immediate aftermath of Trump's election.

What is your expectation for the Fed's monetary policy going forward?

Didier Borowski: We expect the Fed to hike rates by 25bps in December and to continue raising rates at a gradual pace next year. The path is clearly data dependent. The Fed needs some time to ensure that the slowdown in inflation was temporary. As Fed Chair Janet Yellen (and her predecessors) have emphasised on many occasions, there is no preset course for monetary policy.

Because the US cycle is mainly driven by household consumption and debt, the Fed does not really want to tighten monetary policy, preferring to "remove excessive accommodation".

The path for the Fed Funds rate will also depend on fiscal policy. In the run-up to the mid-term elections, we expect Congress to pass some tax cuts (in Q1 2018 at the latest). While the impact on growth and inflation in 2018 is likely to be very modest, explicit support from fiscal policy would extend the duration of the cycle and give the Fed an opportunity to do more than what is currently priced-in. While we expect 2 rates hikes over a 12-month horizon (including the one in December), we should not rule out 3 or even 4 rate hikes of 25bps each next year if fiscal policy becomes more expansionary - but we're not there yet!

With regards to balance-sheet normalisation, there is no preset course here either. The decision will largely depend on broader economic and financial conditions. If the outlook does not deteriorate, the Fed would probably decide to start the process in September. Otherwise, we expect the Fed to postpone its decision to next year. We believe the Fed wants to separate its balance-sheet operations from its monetary-policy decisions. Thus we do not expect the Fed to hike rates and to start the reduction of the balance-sheet at the same FOMC meeting.

What are the major implications of the Fed's monetary policy on US treasuries?

Charles Melchreit:

The FOMC is pursuing tighter monetary policy through two means –the target Fed Funds rate, and soon, through balance sheet reduction. While the Fed has stated that the Fed Funds rate target represents its primary means of changing monetary policy, the balance sheet taper may also have an impact on interest rates and the Treasury market.

We believe that the Federal Reserve will continue to gradually increase rates, not merely in light of their dual mandate for full employment and price stability, but also to foster financial stability. They want to prevent asset bubbles. It is important to recognize that, despite having increased rates by 0.50% since

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December 2016, financial conditions remain easier than before these last two rate increases. In other words, the Fed has more flexibility to raise rates, despite some concerns about recent softness in inflation data.

Balance sheet normalization may have a limited overall impact on Treasury yields in the intermediate term. The initiation of the program in September, however, may result in a short-term sell-off across fixed income markets, as markets digest the reduction in quantitative easing available from the Federal Reserve going forward. However, the tapering initiative has been well-telegraphed to the market so the impact should be priced in. That implies that the operative risk now is that Fed action on the taper does not match the market's interpretation of its intent.

The Fed has indicated it will begin pursue the tapering program by reducing both Treasuries and agency MBS held on its balance sheet. As part of their plan, they currently plan to allow Treasury maturities to run off; U.S. Treasury maturities of 1 year or less account for approximately 13% of their Treasury holdings and a significant portion of their exposures lies in longer-term Treasuries. The Fed has flexibility regarding the maturity profile of balance sheet tapering.

This flexibility is particularly important because investors are concerned about the current flatness of the U.S Treasury yield curve by historical standards, and the potential for yield curve inversion, as the Fed continues to raise short-term rates. Whether or not this concern is justified in this time of extraordinary policy moves, but markets view an inverted yield curve as a precursor to recession. The current 2s-10s yield curve stands at 0.93%, and the 2s-10s 2-year forward curve at 0.64%, well below the long-term average of 1.25%. At some point, the Fed may be motivated to sell longer maturity Treasuries, to manage this inversion risk.

What segments of the fixed income market are expected to outperform, in your view?

Charles Melchreit: Given our outlook for interest rates, and the current low level of Treasury yields, we continue to believe U.S. Treasuries do not offer attractive value, relative to other fixed income sectors. Short-term Treasuries continue to offer negative real yields, adjusted for PCE inflation.

We believe that credit sectors continue to offer value to investors, despite lower spreads. While corporate spreads stand well below average and leverage has increased, corporates continue to offer strong fundamentals. We favor high yield and bank loans over investment grade corporates; investment grade corporate spreads now stand a .09% above their post 2008 lows. We also find pockets of value in certain securitized markets.

What is your outlook on the USD?

Charles Melchreit: We believe the Dollar could depreciate modestly in the near-term, as yield differentials between the U.S. and developed markets narrow, reflecting in part the potential convergence of global central bank policy. The Fed has been more hawkish than its peers, but has taken a cautious approach to tightening policy. Better global growth, which is surprising to the upside, may force the hands of other central banks, leading to cross-border yield compression, and therefore a potentially weaker Dollar.