

Revisiting fixed income opportunities after the European institution appointments



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“The appointments of Christine Lagarde and Ursula Von der Leyen favour the strengthening of the European Union.”

The appointments: The appointment of Christine Lagarde as President of the ECB and Ursula Von der Leyen as President of the European Commission are undoubtedly among the best possible compromises, because these are two women of great experience, both very much in favour of strengthening the European Union. It is very clear that the political dimension has taken over from the technocratic dimension. This is a significant development for European institutions, but it is still too early to draw any conclusions.

Key implications for the Eurozone: The Commission's role will inevitably become more political. For instance, trade negotiations with the rest of the world will take centre stage. The 2021-2027 multiannual financial framework (MFF) currently being negotiated is key for the Eurozone's development. A common budget with stabilisation properties is unlikely, but there is broad consensus about the Capital Markets Union (CMU). This would make it possible to better manage the abundant savings of the Eurozone (excess savings on investment amounted to €340bn in 2018) towards concrete investment needs such as the energy transition, digital innovation and the development of SMEs. It would also facilitate macroeconomic adjustment in the Eurozone.

Key implications for the ECB and monetary policy. At the ECB level, Lagarde should act in continuity with Draghi. In addition, during the next financial crisis, the ECB and governments will have to work in close cooperation and Lagarde is very used to talking to heads of state. On the monetary front, against a backdrop of a weakening economic outlook in the EZ and low inflation, we believe that the ECB will not hesitate to cut its key rates if the Fed cuts rates significantly and/or if the euro appreciates. As a result, we expect the ECB's guidance to change to mention explicitly that rates could be lowered. Finally, we expect the ECB to announce in September a new QE programme targeting corporate bonds. The ECB intends to do “whatever it takes” to avoid a crisis in the EZ.

Opportunities for fixed income investors: At today's yield levels, market participants are now quite sensitive to any better economic announcement. With central banks now dovish, we do not predict a significant increase in yields; we rather anticipate a continuation of the hunt for premium by investors. In this hunt, with Italy avoiding the excessive deficit procedure (EDP), taking a negative view on this country could be quite costly; investors should prefer neutrality with a flattening stance. In the search for higher yield, the subordinated corporate segment is a solution that could offer attractive premiums, with good quality, low duration risk and pretty good liquidity. We reiterate that fixed income markets continue to offer a number of opportunities, notably in the long end of sovereign curves, with flattening trades and credit not being at historical lows, etc. In addition, should central banks become more involved, we should see less spread dispersion in the investment grade universe, which may represent a strong call for the credit value factor.

VIEW ON THE APPOINTMENTS

How do you see the two new top appointments in Europe changing the balance of power in Europe among countries and political forces?

The appointments of Christine Lagarde as President of the ECB and Ursula Von der Leyen as President of the European Commission are the result of a compromise between France and Germany, which takes into account the vetoes of some countries over other candidates. It is undoubtedly one of the best possible compromises because these two women have great experience and are both very much in favour of strengthening the European Union.

- **Ursula Von der Leyen.** In Germany, Von der Leyen is the only minister to have been in government since Angela Merkel became chancellor in 2005. Her continued presence in government is a testament to her political ability (her ability to compromise, in particular).

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Her qualities will be invaluable in view of the divisions in Europe on key issues. Von der Leyen has previously expressed her support for: (1) the construction of a United States of Europe (based on the model of Switzerland, Germany or the USA) with more coordination of economic policies; and (2) the establishment of a European army (an objective which she nevertheless recognises will probably take more than a generation to achieve). That being said, her record as Minister of Defence is highly contested in her own camp.

- **Christine Lagarde (CL).** As for Lagarde, the criticisms are less sharp. Her success at the IMF since 2011 has been widely praised, with her having had to face the sovereign debt crisis and the Greek crisis. Her leadership, pragmatism and open-mindedness have also been recognised. However, her knowledge of monetary policy is rudimentary, which will mean her closest collaborators will play a decisive role. On the other hand, her communication skills have been unanimously recognised. This is a fundamental asset for a central banker nowadays.

It is clear that **the political dimension has taken over from the technocratic dimension**. This is a significant development for the European institutions, but it is still too early to draw any conclusions. Budgetary issues should return to the fore in the coming months. The European Council of December 2018 set an objective of adopting the multiannual financial framework for 2021-2027 in the autumn of 2019; the European Council of 21 June 2019 postponed its horizon to “before the end of 2019”.

IMPLICATIONS FOR THE EUROZONE AND THE ECB

What is your view on the future direction of the European Commission on the relevant matters for the EU? What will the main differences be from the previous Commission and what are the main challenges?

In a particularly uncertain international environment and with economic divergences between Member States still very pronounced, the Commission’s role will inevitably become more political. For instance, trade negotiations with the rest of the world will take centre stage. The challenges are well identified. But Europeans must move fast. It is indeed likely that the EZ (or the EU) will face a recession in the coming years, which will require a consolidation of the economic and financial architecture of the EZ to increase its resilience to shocks.

Indeed, more than 10 years after the great financial crisis, the Monetary Union is still split between surplus countries and countries in deficit. This polarisation weakens public investment and reduces potential growth. The EZ must transform its growth regime and reform its financial architecture. This is the only way to address the economic and environmental challenges in the medium to long run.

There is a unique window of opportunity with the 2021-2027 Multiannual financial framework currently being negotiated, as it will set a path for EZ development for the coming decade on key issues (agricultural and cohesion policies, digital economy, migration, climate objectives, etc.).

Do you see a new impulse for accelerating some integration and reform in the EU? In which areas do you see more likely developments?

At the very least, there is a common willingness to make progress in many areas. However, given the level of political fragmentation, it may take time. A common budget with stabilisation properties is unlikely. A common budget, in the event of a serious shock affecting one or more Member States, could help stabilise their economies. Such a budget, fuelled by national contributions, would make it possible to support the activity of a country facing a crisis, either alone or with the rest of the Eurozone, limiting the use of painful reforms. However, it is clear that a stabilisation budget is not likely to be put in place in the Eurozone as there is no common view (Germany and France are not on the same page), however, there is broad consensus about the **Capital Markets Union (CMU)**. Europeans need to promote risk sharing.

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This would make it possible to better manage the abundant savings of the Eurozone (excess savings on investment amounted to €340bn in 2018) towards concrete investment needs such as the energy transition, digital innovation and the development of SMEs. **It would also facilitate macroeconomic adjustment in the EZ.** In fact, integrated capital markets could cushion asymmetric shocks in a currency union more than fiscal transfers can. For instance, when the shareholding of a company is highly diversified geographically, the profits and losses are more widely distributed. In the US, thanks to integrated capital markets, almost half of the impact of an economic shock is spread among the different states – more than by budget transfers. **The CMU in the Eurozone would reinforce the resilience of the economy.** In addition, the continuation of structural reforms (targeting price flexibility, labour market adjustments, the adoption of flexible corporate insolvency regimes) is needed as these can also contribute to the resilience of the economy.

On the ECB, the consensus is for continuity of Draghi’s approach with Lagarde. Do you agree?

The IMF in general and Christine Lagarde in particular have always supported the ECB’s policy, whether it be QE programmes, TLTROs or negative interest rates.

Moreover, Lagarde has often said, as has Mario Draghi, that monetary policy was not the “only game in town”, and that **low rates should be used to mobilise fiscal policy, where there is fiscal space.** Lagarde is thus expected to act in continuity, which should enable Draghi to implement expansionist measures before she arrives at the ECB without expecting them to be called into question later. The roles and responsibilities of central banks and governments are, in theory, quite distinct.

But with quantitative easing programmes, the boundary between monetary and fiscal policy has been blurred. As a result, during the next financial crisis, the ECB and governments will have to work in close cooperation. Lagarde is very used to talking to heads of states – a skill she developed at the IMF – and this is something that will be useful to her in a monetary zone made up of still very disparate economies. We can already see that Lagarde enjoys the confidence of investors.

What can we expect in the next few months in terms of monetary policy direction and tools from the ECB, amid weak economic data in the Eurozone?

The EZ economies clearly weakened in the second quarter and core inflation has remained excessively low in this cycle, far below the ECB’s target. Against this backdrop, in June, the timeframe for keeping interest rates “at present levels” was extended to “through the first half of 2020”. Draghi also opened the door to further cuts. We believe that the ECB would not hesitate to cut its key rates if the Fed cuts rates significantly and/or if the euro appreciates. As a result, **we expect the ECB’s guidance to change to mention explicitly the fact that rates could be lowered.** Finally, we expect the ECB to announce in September a new QE programme targeting corporate bonds.

The ECB intends to do “whatever it takes” to avoid a crisis in the EZ.

¹TLTRO: The targeted longer-term refinancing operations (TLTROs) are Euro system operations that provide financing to credit institutions for a predefined period of time

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FIXED INCOME INVESTMENT IMPLICATIONS

Given the new appointments, do you see a continuation of falling yields, to what extent and should investors play it?

Markets are discounting a very dovish central bank policy, supported by the most recent official communication as well as economic data. At today's yield levels, **market participants are now quite sensitive to any better economic announcement**, as per sampling of the latest US job report (+224K) or French industrial production (+4% yoy in May). The current economic cycle is mature and relies more and more on internal demand, thus implying we should not expect a sharp acceleration of growth. Inflation remains low and for the ECB, as well as for the Fed, the risk is quite asymmetric. Our main scenario highlights central banks remaining supportive and quite dovish. As a result, we may see a pause in the declining trend of rates. We do not predict a significant increase of yields; we rather anticipate continuity in the hunt for premium by investors.

Italy has avoided the excessive deficit procedure (EDP) and the 10-year BTP spread fell below 200bps, what is your view on Italy?

For Italy, avoiding the EDP was a positive development. The Italian spread remains quite large, especially on 10-year maturities. Taking a negative view on the country could be quite costly and neutrality with a flattening² stance is the right strategy for the time being, in our view. To change track, investors would require the Italian government to strengthen its communication strategy, clarifying further the path towards a possible build-up of long positions, especially ahead of the budgetary discussion.

Where is the oasis of yield in fixed income? What are, in your view, the strategies to deliver returns to investors in the current phase and what are the main risks?

Traditionally, to increase their yield, investors have ended up taking additional liquidity risk (private debt, structured credit), duration risk (classic way to extend exposure at the far end of the curve with sovereign long-dated bonds) or default risk (high-yield). Within the defined low rates scenario unfolding on both sides of the Atlantic, the sub-segment becomes a key area to look at if properly screened. More specifically, **the subordinated³ corporate segment is an alternative high yielding solution**. These securities provide historical premiums over senior debt. The vast majority of subordinated bonds are issued by quality investment grade (IG) names (much reduced default risk), trade to call-date (short-dated, with low duration risk) and are composed of large issuances (with enhanced liquidity). Finally, valuations remain supportive of the subordinated debt sub-segment. Selection is key in this potential space; the ability to research across this complex universe and long-term experience in dealing with these instruments across different market environments are vital to avoid taking unwanted risks. We reiterate that fixed income markets continue to offer a **number of opportunities, notably in the long end of sovereign curves, with flattening trades and credit not being at the historical lows**, etc. In addition, should central banks become more involved, we will see less spread dispersion in the IG universe, **which represents a strong call for the credit value factor**.

² 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

³ Senior and subordinated debt. Subordinated debt is any type of loan that's paid after all other corporate debts and loans are repaid (senior debt), in the case of borrower default. The senior debt takes priority, it is more secure than any other debt.

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