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Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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Coronavirus emergency: Fed cuts rates, but markets expect more

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- ***The cut and the market reaction:*** *In the first intra-meeting ease since the 2008 crisis, the Fed delivered a 50 basis-point rate cut. Market volatility and liquidity concerns have likely been the trigger for the emergency cut. The market reaction has been a sell-off in equities, while the 10-year Treasury yield touched new lows, as the Fed move is perceived as not being enough to offset recent deterioration in financial conditions due to the market reaction to the coronavirus outbreak. Markets still expect more.*

- ***Investment convictions on US fixed income:*** *Selectively, corporate credit appears increasingly attractive, and we keep our positive stance on securitised bonds. While we have a cautious stance on US duration, 30-year treasuries look attractive relative to 10s. Volatility in corporate credit has disproportionately widened spreads in certain sectors and securities. There are opportunities in companies that remain fundamentally strong, with reasonable leverage and liquidity, strong free cash flow, not capital intensive or too dependent on oil prices.*

- ***Views on the other main Central Banks:*** *The other main Central Banks have less room to act, but they will be pressured to follow the easing path to support market conditions and mitigate possible volatility in the currency markets. Concerning the ECB, a further rate cut remains an option, but it looks less effective than other measures in terms of monetary stimulus transmission. On BoJ, we expect more liquidity to be injected into the system, and we keep our previous expectations for 10 bps rate cut in the next 12 months. Regarding the BoE, in our view the probability of a rate cut has materially increased.*

Why did the Fed cut rates between scheduled meetings?

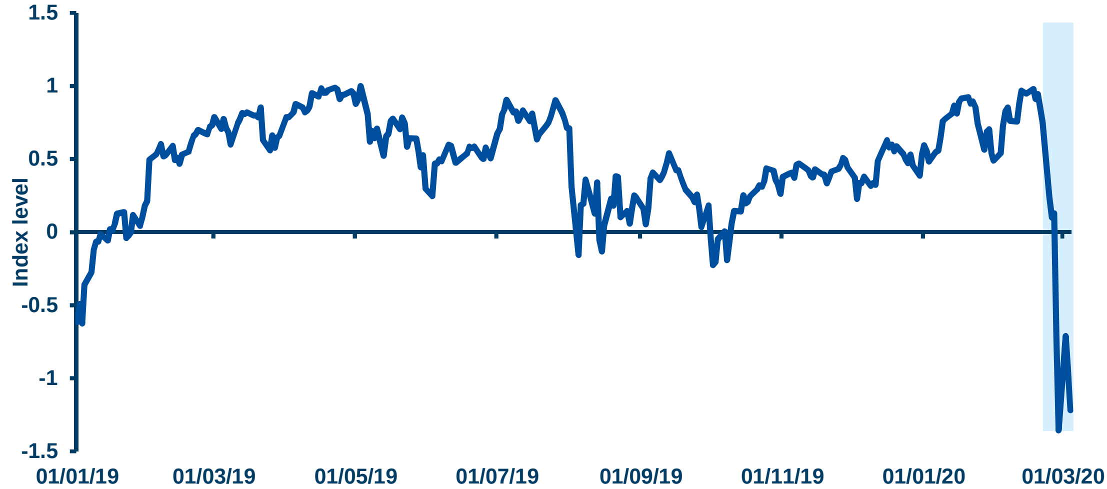
The Federal Reserve surprised markets with a 50 basis point (bps) intra-meeting rate cut – the first intra-meeting ease since 2008, citing **emerging risks to the economy from the Coronavirus**. It was apparent the Fed viewed this emergency rate cut as an **insurance cut** because it reaffirmed that the fundamentals of the U.S. economy remain strong. During the past week, market expectations of a rate cut dramatically increased: as of 4 March, the futures market forecasts approximately two more 25bps cuts by the end of the month, and 25-50bp more in rate cuts in the coming 12 months. We would expect further rate cuts by the Fed. During the press conference, Chair Powell stated that the worsening impact of the virus and growing risks to the economic outlook was the reason for the intra-meeting rate cut.

Why did the market react so strongly to the Fed cut?

The reaction suggests financial conditions still remain tight, and the Fed's action was not enough to offset the recent tightening of financial conditions. Since Feb.19, the Bloomberg financial conditions index has tightened to an equivalent of nearly 50bp of tightening. The Fed's action just offset the recent tightening in financial conditions, but did not provide any additional accommodation.

"The Fed in an emergency move delivered an intra-meeting cut. Markets were expecting the cut and even more in the near future to help ease financial conditions."

Bloomberg US Financial Condition Index



Source: Amundi, Bloomberg. Data as of 4 March 2020.

Following the cut at 10 a.m. on 3 March, US equity markets sold-off 2.8%, while the US 10-year Treasury rallied, with the yield closing at around 1% after dropping to a new record low of 0.904%. The USD index declined by 0.21%, with notable strength in JPY and AUD.

10Y US Treasury Yield

Source: Amundi, Bloomberg. Data as of 4 March 2020.

"Market volatility and liquidity concerns are the likely trigger for the emergency cut."

Does the Fed expect a rapid deterioration of financial or economic conditions with spillover to the credit market?

As the Fed reiterated in its statement, the fundamentals of the US economy remain strong, but the central bank is **worried about the evolving risks to the longer-term US economic outlook**. This is partly due to the reaction to the spread of the Coronavirus around the world, which has so far been muted in the US. The Fed and the G7 are both concerned about the tightening of financial conditions emerging from the falling stock market, widening credit spreads and a weaker US Dollar. The Fed minutes refer to some member's support of "financial stability escape clauses", which may have triggered the emergency cut to temper market volatility and liquidity concerns.

Has the Fed rate cut changed your fixed income convictions and do you see opportunities to benefit from this move?

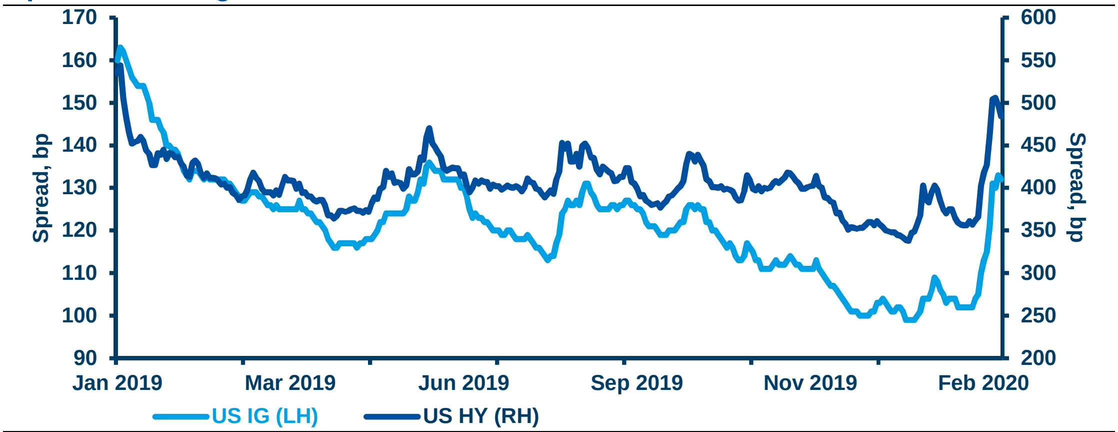
Our convictions are unchanged. **We continue to prefer corporate credit and securitised bonds,** especially as they reflect exposure to residential housing and the consumer. Agency mortgage backed security prices have softened to reflect higher prepayment risk with the sharp

"We continue to prefer securitized bonds vs credit, we keep a cautious duration stance and we seek opportunities in credit areas where the spread widening has been disproportional."

decline in US treasury yields. We remain cautious on US duration. We are contemplating further **weakness in the USD due to potential interest rate convergence as the Fed eases,** and with the increased likelihood of broad-based fiscal stimulus.

As active managers, we are identifying opportunities to benefit from current market conditions. **Volatility in corporate credit has disproportionately widened the spreads in certain sectors and securities.** There are opportunities in companies that remain fundamentally strong, with reasonable leverage and liquidity, strong cash flow, and which are not dependent on high capital expenditures. There is also an active new issue market, creating opportunities in companies in which we have high conviction. Sectors and securities that have lagged the widening are less attractive and can be targets to reduce exposure. **Given high levels of uncertainty, investors should be patient and selective in exploiting entry points in corporate credit.**

Spread widening in US IG and HY markets



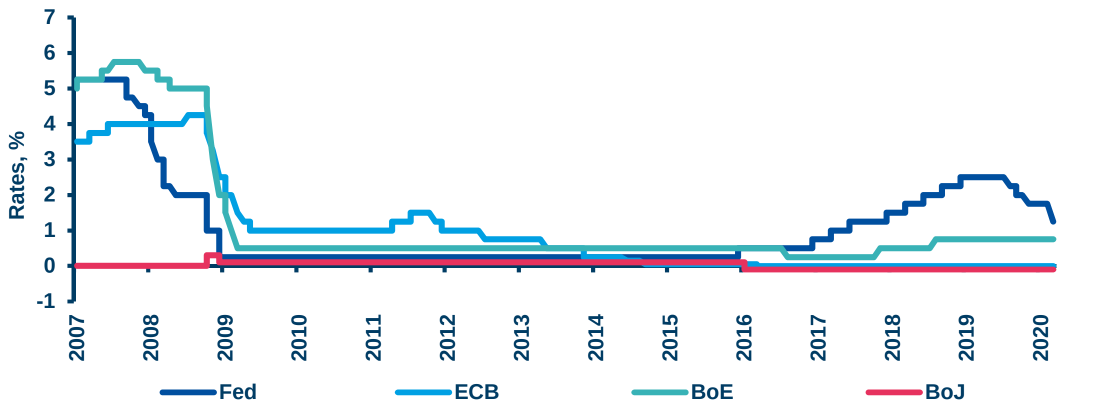
Source: Amundi, Bloomberg. Indexes by ICE BofA .Data as of 4 March 2020.

"The other main Central Banks have less room to act, but they will be pressured to follow the easing path to support market conditions and mitigate possible volatility in the currency markets."

What is your view on the other main Central Banks?

The other main Central Banks have less room to act, but they will be pressured to follow the easing path to support market conditions and mitigate possible volatility in the currency markets.

Central Banks nominal rates



Source: Amundi, Bloomberg. Data as of 4 March 2020.

European Central Bank:

- Mentioning risks for both the macro and financial outlook, the ECB joined other major central banks in opening the door for more accommodation to come, despite limited margins of maneuver for further rates cuts.

- "Appropriate and targeted measures" cited by the ECB point to more efforts in support of liquidity and financial conditions: we expect the ECB to focus on leeway offered by more QE and by renewed measures on long term refinancing operations.
- A further rate cut remains an option, but it looks less effective than other measures in terms of monetary stimulus transmission.

Bank of Japan:

- In line with the statements released by other major central banks, the BoJ communicated that it will provide ample liquidity to ensure stability in financial markets, through appropriate market operations and asset purchases.
- Therefore, we expect more liquidity to be injected into the system, and we keep our previous expectations for 10 bp rate cut over the next 12 months.
- At the same time, we expect the central bank to keep focusing on the slope of the curve, in order to maintain the effectiveness of monetary stimulus.

Bank of England:

- Within a broad turn to a more accommodative stance of G4 central banks, the Bank of England stated that it's working "to ensure all necessary steps are taken to protect financial and monetary stability."
- Within a sort of synchronised global easier policy scenario, therefore, markets turned to imply two rate cuts by the BoE in the next 12 months, the first of which is expected in the short term.
- In our view, the probability of a rate cut has materially increased, despite the BoE's move to keep rates on hold in recent meetings.

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Definitions:

- **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.
- **Volatility:** 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.

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