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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

Is it Time to Add Duration to Fixed Income Portfolios?

Jonathan DUENSING
Senior Managing Director
Head of Fixed Income, US
Portfolio Manager

Meredith BIRDSALL
Senior Vice President,
Senior Client Portfolio
Manager, Fixed Income

Summary Points

- Historically, inflation in the US has never been "tamed" without the federal funds rate exceeding the rate of inflation. In our view, recent market pricing and economic forecasts anticipate a positive real federal funds rate in mid-2023. We believe this suggests that now is an appropriate time to add duration to fixed income portfolios.

- Intermediate term bonds have historically helped diversify equity risk in investor portfolios. We believe this diversification potential may be even more valuable in the current market environment. Intermediate bonds, as measured by the Bloomberg US Aggregate Index, sustained their worst-ever loss year to date as of June 13, 2022. We believe valuations may provide a generous cushion for any future rate increase or spread widening event, and intermediate bonds can potentially provide valuable diversification relative to cash or shorter-duration bonds in a period in which equities experience a sharp selloff.

Over the past few months, US Treasury yields have risen sharply with the market pricing in a more aggressive path for the US Federal Reserve rate hikes. In March, the Fed forecast a peak federal funds rate of 2.8% in 2023[1]. But since that time, Federal Open Market Committee members have become much more vocal about inflation risks, and as of June 14, the market anticipated the federal funds rate peaking at 4.055% in May 2023, pricing in a 3.47% 10-year yield. Will these rates be sufficient to rein in inflation, suggesting that longer-term yields may have seen their cyclical highs? If yields have peaked, can core bond portfolios reclaim their traditional role as an anchor in investor portfolios, diversifying equity risk?

Historically, inflation in the US has never been "tamed" without the federal funds rate exceeding the annual inflation rate. "Real rates would need to be high enough to slow the economy to rein in inflation, and negative real rates won't do much to achieve that," former Fed governor Eric Rosengren[2] said. "The terminal rate certainly needs to be higher than the inflation rate." In other words, the inflation adjusted, or "real", federal funds rate must be positive—one indicator of restrictive financial conditions--in order to slow growth and control inflation. An analysis of the difference between the market implied Fed Funds rate and consensus forecasts of the annual core personal consumption expenditures (PCE) index reveals an anticipated positive real Fed Funds rate by mid-2023. Assuming inflation's path follows consensus over the next 12-16 months, interest rate markets already price in a real Fed Funds rate in the future. Now it's up to the Fed to deliver on what the investment markets have already discounted.

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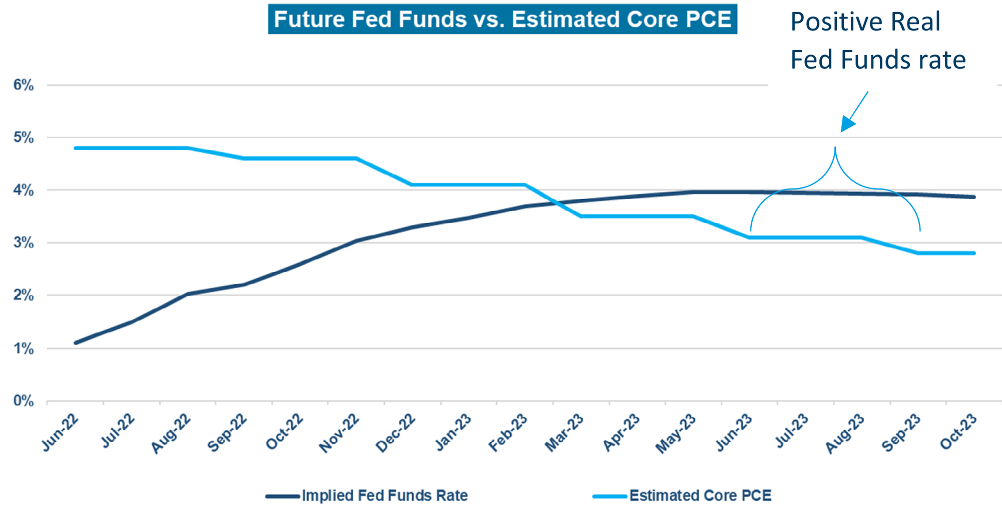
Positive Real Federal Funds Rate Expected in Mid-2023

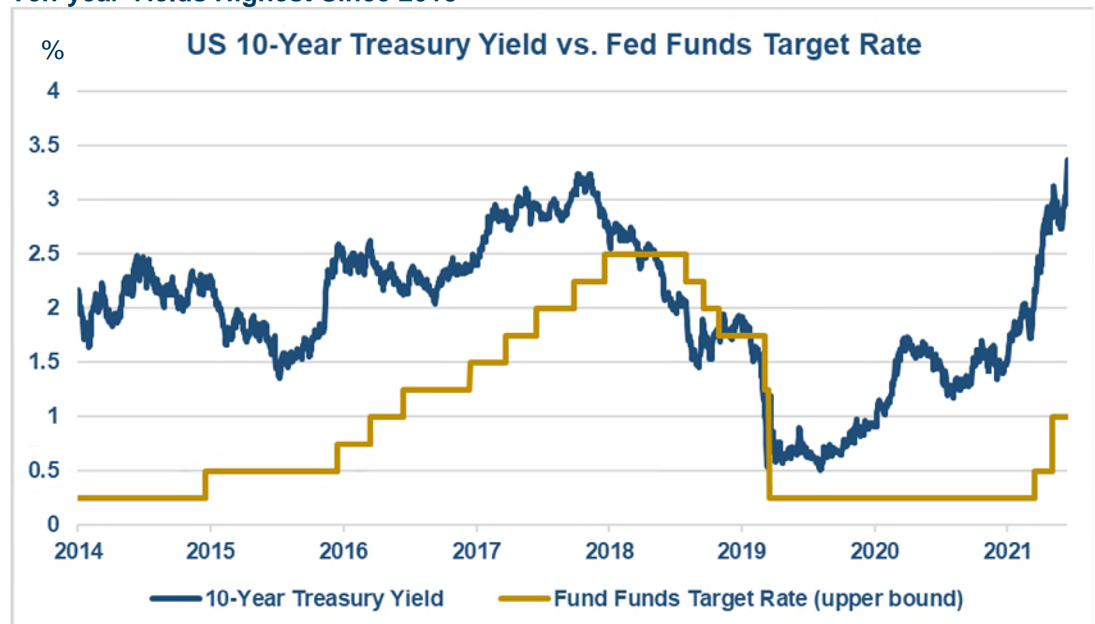


Source: Bloomberg for Fed Funds Futures Contracts and Economic Forecast. Private Core PCE estimate from Bureau of Economic Analysis (BEA). Data as of 6/13/22.

Ten-Year Yields May be Nearing Cyclical Peaks

Ten-year yields stood at 3.47% on June 14, having risen from a near-term low of 1.18% in August of 2021, and from 1.5% at year-end 2021. In the last rate hike cycle, from early 2016 to early 2019, the 10-year yield saw a high of 3.23% in November 2018. We anticipate the 10-year yield may settle in the range of 3.25%-3.50%. This level is also consistent with our view that the 10-year yield should include a term premium above the neutral federal funds rate, which the Fed currently estimates at 2% to 3%.

Ten-year Yields Highest Since 2018



Source: Bloomberg, 10-year U.S. Treasury yield; Target Fed Funds Rate, 6/14/22.

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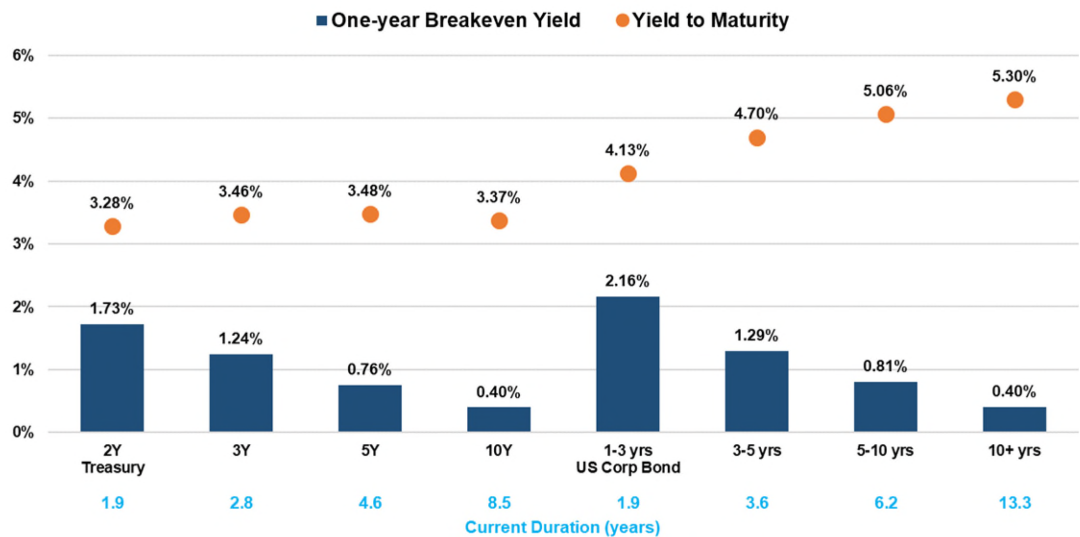
Higher Yields as a Buffer

"For intermediate bond investors, any increase in real yields may be partly offset by moderating inflation expectations."

We believe the sharp interest rate increases in response to recent "jawboning" by Fed members have made intermediate duration bonds a compelling investment, in our view. Intermediate bonds, as measured by the Bloomberg US Aggregate Index, provided a yield of 4.04% as of June 13, compared to 1.75% at the beginning of the year, offering a significantly greater cushion to mitigate any further downside risk sustained from higher Treasury yields or wider credit spreads. Even if a more aggressive Fed drives real yields higher to contain inflation, any loss would likely be buffered by the higher yield. In addition, to the extent rising yields are driven by Fed rate increases, these increases would be most fully reflected in the shorter end of the curve. For intermediate bond investors, any increase in real yields may be partly offset by moderating inflation expectations.

How Much Cushion Exists for Further Spread/Yield Moves in Bonds?



Source: Bloomberg as of 6/13/22. Source: Chart shows US Treasury yields for the indicated maturities and the ICE BofA US Corporate Bond indices in the maturity ranges shown. One-year breakeven yield is the current yield divided by the current duration. Unlike Treasury securities which are backed by the full faith and credit of the US government, corporate bonds have more risks, such as credit and liquidity risk. **Data based on past performance, which is no guarantee of future results.**

High Equity Multiples Highlight Importance of Diversification from Bonds

Intermediate bonds have historically helped to diversify equity risk and we believe that diversification[3] potential is as valuable as ever in the current market environment. The following chart details historical return correlation between the Bloomberg US Aggregate Bond Index and the S&P 500 Index (S&P 500) over the past ten years. In general, the return correlation tended to be negative. After the recent "rate shock", we anticipate that the bond-equity return correlation will revert back to the longer-term negative relationship.

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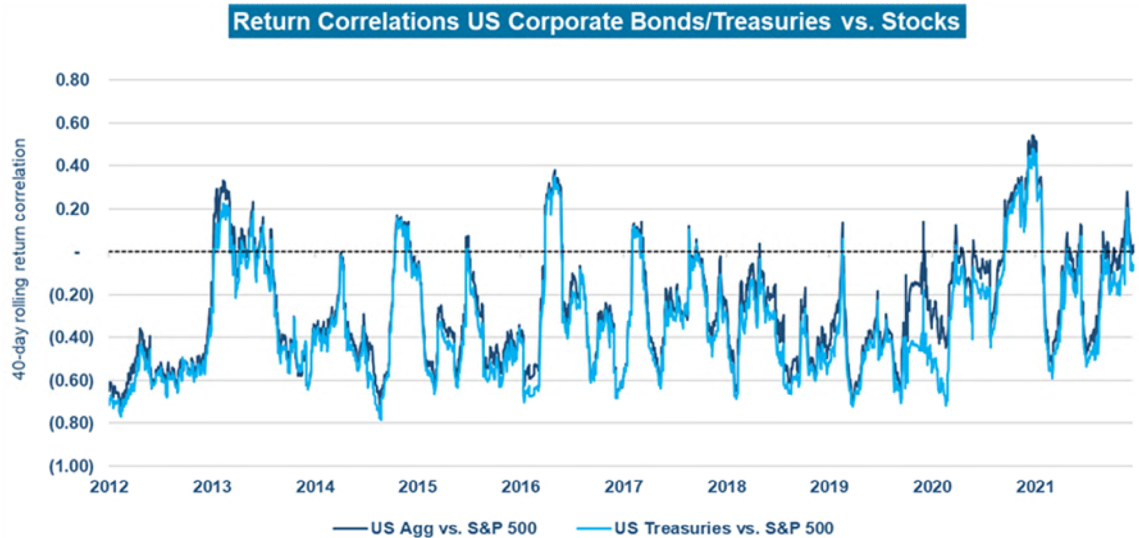
"Intermediate bonds have historically helped to diversify equity risk and we believe that diversification potential is as valuable as ever in the current market environment."

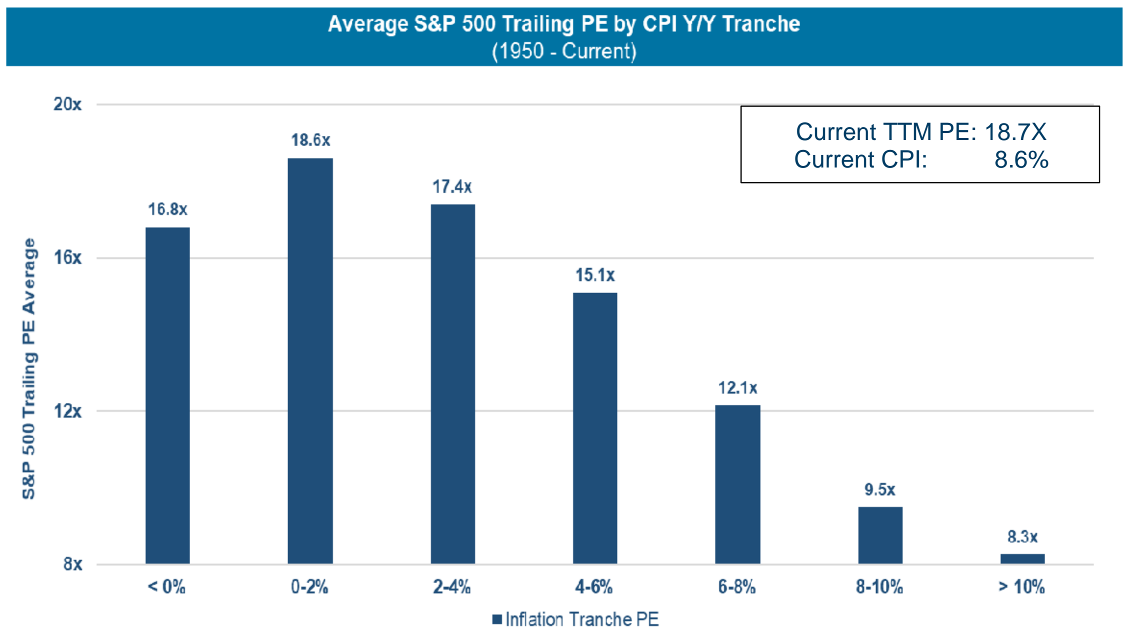
Can Bond/Equity Return Correlations Return to their Long-Term Negative Relationship?



Source: Bloomberg, July 13, 2022. Returns of Bloomberg US Aggregate Index, 10-Year Treasuries, S&P 500 Index. Past performance does not indicate future results.

In addition, equity multiples stand at high levels relative to inflation as of June 14. The S&P 500 Index traded at 18.7 times the latest trailing 12-month price/earnings ratio, with headline CPI at 8.6% (see below). Even reverting to the market forecast of CPI at 6.3% by year end, the following chart, which compares historical equity multiples to inflation levels, indicates downside risk to equities.

Historically, Higher Inflation Has Meant Lower Price/Earnings Multiples



Source: Chart - Strategas. Data as of March 31, 2022. Price/Earnings multiple, or PE, is a valuation measure of expensiveness using a stock's price divided its by per-share earnings. Bloomberg, Current TTM PE and Headline CPI YOY, June 14, 2022. Past performance is no guarantee of future results.

In our view, this downside risk further supports the importance of a diversified portfolio, and the best diversifier to equity risk over time has been duration available in bonds. During quarterly periods (and year-to-date 2022) when equities have fallen by 10% or more, the Bloomberg US Aggregate Bond Index returned an average of about 1.9% during this same period.

Uncorrelated Returns: Periods of Equity Market Drops of 10% or More

Quarter	S&P 500 Index	Bloomberg US Aggregate Bond Index
Q 2008	-21.94	4.58
Q1 2020	-19.60	3.15
Q3 2002	-17.28	4.58
Q3 2001	-14.68	4.61
Q3 2011	-13.87	3.82
Q4 2018	-13.52	1.64
Q2 2002	-13.39	3.69
YTD 6/13/22	-20.79	-12.10
Q1 2001	-11.86	3.04
Q2 2010	-11.43	3.49
Q1 2009	-11.01	0.12
AVERAGE	**-15.40**	**1.87**

Source: Bloomberg. Data as of June 13, 2022. Past performance is no guarantee of future results.

Conclusion: We Believe Now May Be the Time to Add Duration

Intermediate bonds, as measured by the Bloomberg US Aggregate Bond Index, sustained their worst ever loss year-to-date through June 13, 2022. But investors would be wise to consider that past performance does not predict the future.

- As a consequence of the sell-off, US Aggregate yields have risen from 1.75% at the beginning of the year to 4.04% as of June 13 in anticipation of continued FOMC hikes to the Fed Funds rate. Recent valuations provide a generous cushion for any future rate increase or spread widening event. We believe it is unlikely yields will rise significantly higher given our expectation for positive real Fed Funds rates in mid-2023.

- We believe intermediate bonds can potentially provide valuable diversification relative to cash or shorter-duration bonds in a period in which equities experience a sharp selloff.

Index and Term Definitions

The historical index performance shown is provided to illustrate market trends and is not intended to represent the past or future performance of any Amundi US product. Indices are unmanaged and their returns assume reinvestment of dividends, and unlike investment products returns, do not reflect any fees or expenses. It is not possible to invest directly in an index.

S&P 500 Index – A commonly used measure of the broad US stock market**.**
Bloomberg US Aggregate Bond Index – A measure of the US bond market. Subset includes Bloomberg Non-Agency CMBS Aggregate Total Return Index (Unhedged).
ICE BofA 3-month Treasury Bill Index – Comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month that issue is sold and rolled into a newly selected issue.

Correlation – The degree to which assets or asset class prices have moved in relation to one another. Correlation ranges from -1 (always moving in opposite directions) through 0 (absolutely independent) to 1 (always moving together).
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**.**
Price to Earnings (P/E) Ratio – The price of a stock divided by its earnings per share

Asset Class Risk
Equity: Stock markets and investments in individual stocks involve certain risks, including issuer, market, economic, industry, political, regulatory, geopolitical, and other risks. Investment return and principal value may go down as well as up and could result in the loss of all capital invested.
Fixed Income: Fixed income investments are subject to certain risks, including interest rate changes and possible loss due to financial failure of issuers; investments in high yield or lower rated securities are subject to greater volatility, illiquidity and possibility of default.

Important information

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[1] Bloomberg Economic Forecasts, 6/8/22
[2] Goldman Sachs Group, “Top of Mind, Stagflation Risk,” Issue 107 , March 14, 2022
[3] Diversification is not a guarantee and does not protect against loss