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Amundi ASSET MANAGEMENT

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Remain agile in bond selection, with an eye on last mile inflation

INVESTMENT TALKS

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Executive summary

- *Markets have been reassessing their expectations of US Federal Reserve policy rate cuts.*
- *We remain agile in fixed income markets with a focus on quality.*
- *While we are cautious on high yield, we are looking for opportunities in securitized credit, higher-rated corporate credit and insurance-linked securities.*

Expectations for US Federal Reserve policy moves

In our view, the current market-implied pricing of Fed rate cuts in 2024 is no longer unreasonable, and we see good value in the front end of the US Treasury curve (two- to five-year maturities).

While market pricing of possibly up to two 25-basis-point rate cuts in 2024 is a reasonable baseline for a soft-landing inflation scenario, we are considering other potential outcomes. Though the US economy and consumers appear to have largely defied the "gravitational pull" of significantly tighter monetary policy, we continue to view the risk of a recession during 2024 as higher than normal. We expect that such a recessionary scenario would lead to significantly greater interest rate cuts, while the "no landing" scenario of more persistent inflation would delay the start of rate cuts. As such, the overall distribution of outcomes for the federal funds rate in a year's time is skewed to the downside, with the weighted average across future scenarios lower than current market pricing.

We remain concerned about a steepening of the US yield curve, however. The US government annual deficit, currently at 6.3% of gross domestic product, is elevated by historical (and non-recessionary) standards and will increase significantly in coming years if current laws governing taxes and spending remain unchanged. On its projected path, persistent budget deficits will increase federal debt held by the public far beyond any previously recorded level, and investors will likely demand a higher term premium to hold more Treasury notes and bonds. In the medium term, we see the elevated likelihood of a return of the "bond vigilantes" similar to that of the early 1990s, a scenario in which significantly higher long-term Treasury yields are required to force Congress to enact the fiscal adjustments necessary to reduce deficits to a sustainable level.

Positioning and Potential opportunities

After the recent interest rate repricing, US risk-free markets offer reasonable long-term value, while spreads remain historically narrow across most credit-sensitive sectors and do not adequately compensate for lingering macro uncertainties and tighter market liquidity. We are positive on duration given relatively attractive real and nominal risk-free interest rates, but with a bias to short and intermediate-term maturities. Specific to sector allocation, our views are largely unchanged, as relatively narrow credit spreads justify lower-than-normal exposure to spread risk, and we continue to selectively favor higher-quality and shorter-duration exposure within spread sectors. We prefer investment-grade, particularly the financial sector, to high yield. While we are cautious on high yield, we consider other higher yielding alternatives, such as insurance-linked securities, which generally also exhibit low correlations to traditional fixed income and equity investments. Outside the US, we remain agile on global allocations, particularly in global quality credit and in emerging market bonds.

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Fixed income outlook

Global & European fixed income	US fixed income	EM bonds
▪ **On Japan, we are cautious** and are monitoring Bank of Japan actions.	• We **are positive on duration** amid progress on inflation but are flexible. • **We prefer investment grade (IG) to high yield (HY)** and within IG we like **financials**. In addition, the **intermediate part of the credit curve** and shorter maturities offer better value. • We are cautious in HY but look for higher-rated credit and insurance-linked securities. **We are also mindful of liquidity.**	▪ **Continuing disinflation, robust emerging markets (EM) growth** and potential Fed easing are positive factors. ▪ **We like corporate debt but favor HY over IG,** given attractive relative valuations and better carry.

Conclusion

As many developed economy central banks continue to grapple with when to start normalizing local monetary policy, now could be an interesting time for investors to strengthen their portfolios by extending the duration of their fixed income portfolios and raising credit quality and liquidity profiles while carefully weighing global opportunities.

Index and Term Definitions

- European Central Bank: The central bank of the eurozone manages the euro and frames and implements EU economic & monetary policy.
- Inflation-linked securities: Financial instruments that allow investors to speculate on a variety of events, including catastrophes such as hurricanes, earthquakes and pandemics.
- US Federal Reserve: The central banking system of the United States, created on December 23, 1913, with the enactment of the Federal Reserve Act.

Important information

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