

24 September 2018 /// n°20-2018

Fed will end reinvestments

Key Points

- Fed will communicate 2019 balance sheet policy
- Higher yields no hurdle for risky assets (equities, emerging bonds)
- Lower volatility in equities and rate markets
- Italy to unveil fiscal outlook
- Brent rise above \$80

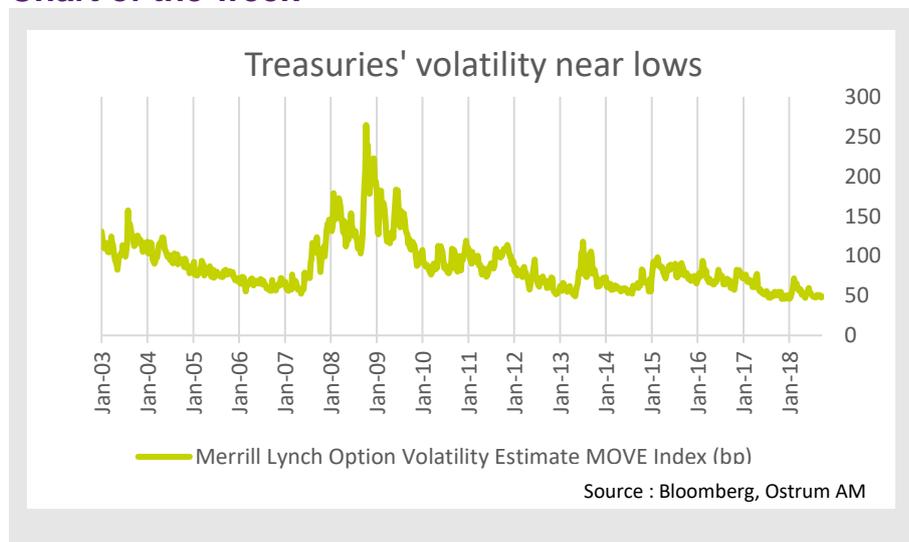
Investor sentiment improved considerably. The implementation of new US tariffs on China's exports has had little market impact. The US dollar even fell last week. Market volatility came down across the board. Asian stock markets, including Shanghai went up 4% last week. European markets gained 2%.

Emerging debt in US dollars (-12bp) and local currency (-6bp) attract inflows again. As concerns exchange rates, the Brazilian real (+3%) benefitted from the more supportive backdrop. The yield on 10-year note increased by 9bp to 3.08% before the

FOMC meets on Wednesday. Bund (0.50%) outperformed in a bearish bond market. Italian bonds trade about 240bp spreads against Bunds as the government is set to unveil its fiscal programme. In the UK, 10-year breakeven inflation rates (+11bp) reacted to upside surprise on retail prices and the persistent tensions in oil prices (Brent at 80\$).

Euro credit tightened modestly in the investment grade universe. The average spread on euro IG stands at 113bp. Speculative-grade bonds rallied by as much as 18bp.

Chart of the week



The Fed has been reducing its monetary support to the economy since 2015. The balance-sheet has been contracting since the fourth quarter of 2017.

The Fed's crystal-clear communication helped to reduce uncertainty, hence the low levels in rates and volatility.

Current policy is increasingly at odds with strong economic conditions and higher inflation. The normalization of the Fed's role in financial markets may be accompanied by higher volatility.

Powell may announce the end of bond reinvestments

The FOMC scheduled on September 25-26 is without a doubt this week's market-mover. A 25bp hike in the Fed Funds rate appears a certainty and, in all likelihood, an additional rate increase will occur next December. Growth conditions, employment gains and price dynamics all point to the need for tighter monetary policy. Furthermore, Fed governor Richard Clarida will contribute his dot for the first time, which has the potential to move the all-important median Fed Funds rate.

In June 2017, Janet Yellen laid down the path for balance sheet normalization until the end of 2018. With just three months remaining, it's about time for Jerome Powell to communicate its balance sheet policy for next year. Over the full year 2018, Treasury bond proceeds will amount to \$425b, of which the Fed committed to reinvest a total of \$173b. In the fourth quarter of 2018, the Fed's portfolio will shrink by \$150b, with \$30b worth of Treasuries and \$20b worth of MBS maturing each month. In 2019, \$365b Treasuries held by the Fed will mature. On current policy principles, the Fed would cease to reinvest Treasury bond proceeds starting in January (i.e. 12 months at \$30b a month equals \$360b). From the point of view of the US Treasury department, this will entail additional borrowing requirement on top of the forecasted 2019 deficit worth about \$1T. At the end of the day, what's at stake is Fed independence. Restoring Fed independence is indeed the reason for monetary policy normalisation. As regards Fed holdings of mortgage-backed securities, refinancing activity has plummeted amid higher long-term rates, so that MBS bond proceeds have fallen. Without outright MBS sales, the reduction in Fed balance sheet will be slower than planned.

Bund and T-note about turning points

In terms of bond strategies, 10-year notes appear close to fair value (which we see at 3.05%) Short speculative positioning have increased considerably, which may reduce selling pressure at the margin. That said, a break above 3.12% would represent a strong sell signal. In the euro area, Mario Draghi pointed to signs of robust core inflation ahead. After these comments, Bund yields moved up to 0.5%, an important technical reference which, if broken, could lead to 0.64%. Core inflation is rather stable near 1%y. Oil in euro terms keeps overall inflation close to 2%, but a slowdown in prices to 1.5%y by next June looks likely. We hold on to a neutral stance but monitor the position carefully. Breakeven inflation rates (unchanged near 140bp on OATe) seem to invalidate the ECB President's forecast. Conversely, upside surprise on UK's RPI

inflation (3.5%y in August) did lead to sharp 10-year breakeven widening (+11bp last week) whilst suppressing real bond yields (-6bp). In Japan, The BoJ's alleged tolerance for slightly higher yields lead us to expect further widening in 10s30s spreads.

This week's other major market-mover is likely Italy's budget outlook which will be published on September 27. The market settles near 245bp spreads currently. The months to come will prove challenging given the high risk of rating downgrades (S&P, Moody's). Caution remains warranted in BTP markets. Conversely, Spain's Bonos appear better supported by PSPP flows and Portugal's sovereign bonds (deficit of 0.7pp of GDP in 2018) remain well oriented.

Rebound in risky assets, short volatility bets return

In equity markets, tensions have eased. Implied volatility levels have come down... and short volatility positions (via VIX futures in the US) are back to levels seen earlier this year. As in rate markets, uncertainty measured by market instruments is very low. Trade tensions between China and the US have now less impact on market participants' psychology than before. Dollar weakness in current market circumstances is considered a risk-on signal. Discounted valuations (emerging, some sectors in Europe) attract investor interest. Equity selling pressure has moderated. In the US, growth stocks remain star performers. A PE gap of fully 8 points has opened between growth and value stocks. That said, ETF flows hint at a possible rotation into value. In the euro area, the auto sector benefits from reallocations jumping by fully 4% last week. The rebound in bank stocks, from lows valuations of 0.7 times their book value, is also continuing.

The decline in volatility echoes the rally in spreads in the US and the return of carry trades. In the euro area, the rise in risk-free rates was cushioned by spreads in euro investment grade credit markets (113bp). Speculative-grade bonds (346bp over Bunds) rallied significantly last week (-18bp). That said, final investor flows remain hesitant across euro IG markets possibly because of the lack of ECB CSPP reinvestments over the 12 months to come.

Narrowing emerging bond spreads

In emerging markets, dollar depreciation enabled significant inflows into emerging debt funds, in both local and hard currencies. The average spread has now dropped below 350bp (EMBI Global Diversified). Performances over the past three months are now flat. Fragilities do remain but the US mid-term elections could prove a turning point for emerging markets.

Main Market Indicators

G4 Government Bonds	24-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.51 %	+2	+9	+12
EUR Bunds 10y	0.51%	+5	+17	+8
EUR Bunds 2s10s	102 bp	+3	+8	-4
USD Treasuries 2y	2.81 %	+3	+19	+93
USD Treasuries 10y	3.08 %	+9	+27	+67
USD Treasuries 2s10s	27 bp	+6	+8	-26
GBP Gilt 10y	1.61 %	+8	+34	+42
JPY JGB 10y	0.13 %	+2	+3	+9
€ Sovereign Spreads (10y)	24-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	32 bp	+1	-2	-4
Italy	244 bp	+5	-37	+85
Spain	101 bp	-2	-4	-13
Inflation Break-evens (10y)	24-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	140 bp	+1	+0	-3
USD TIPS	216 bp	+5	+6	+18
GBP Gilt Index-Linked	318 bp	+13	+12	+12
EUR Credit Indices	24-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	113 bp	-3	-2	+27
EUR Agencies OAS	48 bp	+0	-3	+10
EUR Securitized - Covered OAS	49 bp	+1	-5	+9
EUR Pan-European High Yield OAS	346 bp	-18	-8	+52
EUR/USD CDS Indices 5y	24-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	70 bp	+10	+3	+25
iTraxx Crossover	271 bp	-11	-18	+38
CDX IG	62 bp	+5	+2	+12
CDX High Yield	316 bp	-5	-13	+8
Emerging Markets	24-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	344 bp	-12	-20	+59
Currencies	24-Sep-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.176	+0.83	+0.59	-2.07
GBP/USD	\$1.312	-0.11	+1.75	-2.91
USD/JPY	¥112.74	-0.35	-1.5	-0.04
Commodity Futures	24-Sep-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$81.0	\$2.9	\$4.8	\$17.0
Gold	\$1 199.1	\$0.7	-\$10.9	-\$103.7
Equity Market Indices	24-Sep-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 919	1.06	1.55	9.19
EuroStoxx 50	3 410	1.92	-0.50	-2.67
CAC 40	5 476	2.38	0.80	3.08
Nikkei 225	23 870	4.59	5.61	4.85
Shanghai Composite	2 797	4.32	2.49	-15.41
VIX - Implied Volatility Index	12.55	-8.26	4.67	13.68

Source: Bloomberg, Ostrum Asset Management

Writing



AXEL BOTTE
STRATEGIST
 axel.botte@ostrum.com

Legal information

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

In the E.U. (outside of the UK): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. **France:** Natixis Investment Managers Distribution (n.509 471 173 RCS Paris). Registered office: 43 avenue Pierre Mendès France, 75013 Paris. **Italy:** Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. **Germany:** Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. **Netherlands:** Natixis Investment Managers, Netherlands (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. **Sweden:** Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 Str, Stockholm 111 35, Sweden. **Spain:** Natixis Investment Managers, Sucursal en España. Serrano n°90, 6th Floor, 28006, Madrid, Spain.

In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the U.K.: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). The fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Japan: Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2017 FSC SICE No. 018, Tel. +886 2 2784 5777.

In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Ostrum Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.

In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only.

In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Latin America: Provided by Natixis Investment Managers S.A.

In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627.

In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors.

In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. Past performance information presented is not indicative of future performance.

Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

All amounts shown are expressed in USD unless otherwise indicated.



www.ostrum.com

Ostrum Asset Management
 Registered Office: 43, avenue Pierre Mendès-France – 75013 Paris – Tel. +33 1 78 40 80 00
 Limited Liability Company, Share Capital €50,434,604.76
 Regulated by AMF under n°GP 90-009
 Company Trade Registration (RCS) Number 329 450 738 Paris