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Market views and strategy

Ostrum ASSET MANAGEMENT

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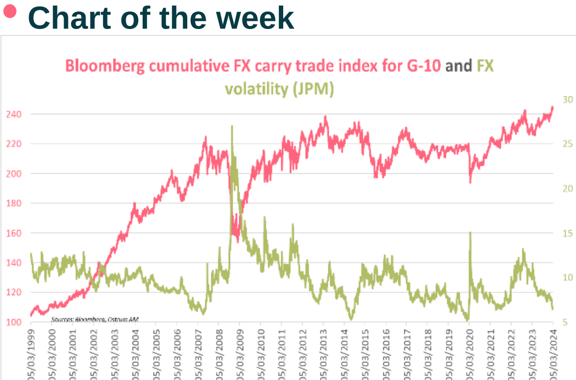
Topic of the week: EM Investment Grade sovereign hard currency debt has earned its reputation!

- **The EMBIGD Investment Grade index spread is now aligned with that of US IG corporates;**
- **This reflects the significant improvement in macroeconomic fundamentals, including low debt levels combined with a good quality sovereign rating;**
- **This improvement also explains the resilience of the asset class in an environment of high volatility in US sovereign bond markets;**
- **Central banks that were the first to raise policy rates are now reaping the rewards;**
- **Decoupling of EM IG sovereign hard currency debt seems to be a given.**

Market review: The confidence game

- **The ECB lowers its 2024 inflation forecast;**
- **Powell's confidence on the disinflation process;**
- **Italian BTP spreads shrinking to 130 bp;**
- **Equities and CDS react positively to central banks' messages.**

Chart of the week



The Bloomberg cumulative FX Carry-Trade index for G-10 currencies reached an all-time high. The necessary condition for carry-trade strategies to work is the absence of volatility. It has fallen significantly since October 2023.

The yen has been used primarily as a funding currency for these strategies. Market operators borrow the Japanese currency to buy dollar. The appreciation of the greenback over the period increases the gains of the carry-trade strategy.

Figure of the week

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Source : Bloomberg

Egypt devalued its pound by 35% and raised its policy rate by 600 bps, paving the way for the release of IMF financial support of more than $10 billion.

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● Topic of the week

EM Investment Grade sovereign hard currency debt has earned its reputation!

This week, we are shedding light on emerging market "Investment grade" (IG) sovereign hard currency debt, that is of good credit quality. EM sovereign debt is often seen as a homogeneous bloc. However, we think it is important to highlight the nuances, in particular the resilience of EM IG sovereign debt which has navigated in an environment of high volatility in global bond markets, particularly in the US. In 2023, EM IG sovereign debt returned 7.1%, a 2% outperformance over developed government bonds.

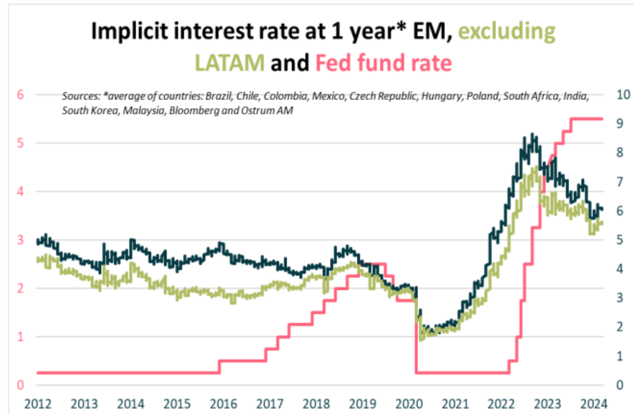
The lessons of the past have been learned!

Improvement of the monetary and fiscal framework

The resilience of emerging markets is no coincidence. After the major crises, such as those in Latin America in the 1980s and the Asian crisis in the 1990s, emerging countries improved their monetary and fiscal policy frameworks to reduce their external vulnerabilities. Their foreign reserves have increased considerably. Many countries have also adopted a flexible exchange rate regime that contributes to macroeconomic stability once the exchange rate adjustment has been made. The structure of their public debt has also shifted towards debt denominated in local currencies, attracting both foreign and domestic investors with less dependence on foreign capital.

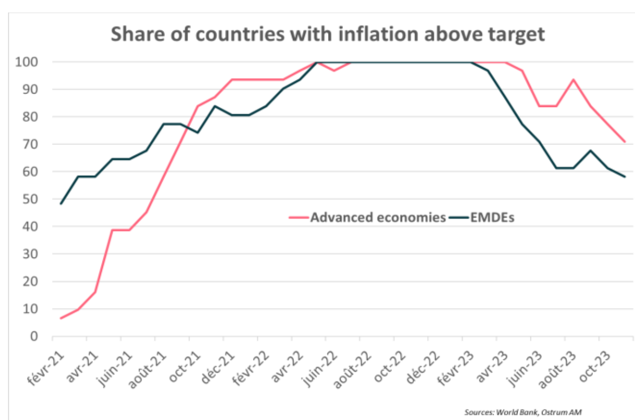
The credibility of central banks strengthened!

The most important point to emphasize is the strengthening of the credibility of central banks in emerging countries, especially after the Covid-19 crisis. Thus, in March 2021, before the Fed, many central banks in emerging countries, particularly in Latin America, had already made aggressive increases in their policy rates to fight inflation, as shown in the chart below.



On average, the central Banks of the 11 emerging countries represented above raised their policy rates by 700 bps over the 2021-2022 period, compared to 550 bps for the Fed. The high interest rate differential with the United States has provided a buffer against external tensions. Higher commodity prices over the period also dampened the effect of monetary tightening on their economies.

This allowed inflation to rapidly converge towards the target, as shown in the chart below, representing the percentage of countries with inflation above the target, including so-called "advanced" countries.



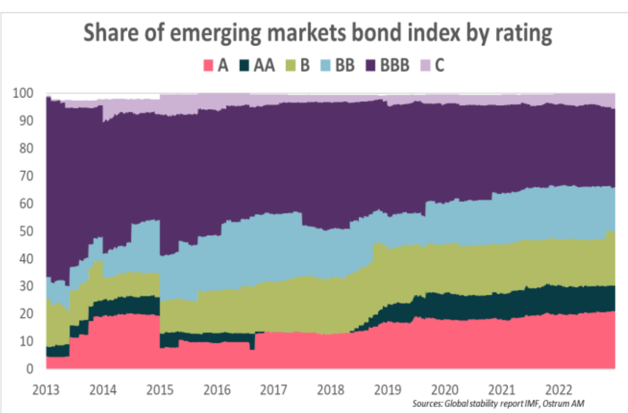
60% of emerging markets have inflation above the Central Bank's target, almost the level of February 2021. On the other hand, 70% of so-called "advanced" countries still have an inflation rate higher than the target, compared to less than 10% in February 2021. The rapid convergence of the inflation rate towards the target in many emerging countries has enabled them to initiate their cycles of rate cuts.

Towards a definitive decoupling?

A significant improvement in the credit profile…

The spread of the JPM EMBIGD "Investment grade", IG, has tightened significantly reaching levels before the financial crisis of 2009, as shown in the chart below.

When SVB Bank failed in March 2023, the EMBIGD IG spread held up better than its counterpart for US IG-rated companies. Indeed, the spread of US IG companies widened by 40 bps between late February and mid-March 2023, while the EMBIGD IG spread widened by only half, to 23 bps. This reflects changes in the composition of the EMBIGD IG index, which now includes many Gulf countries, oil and gas exporters, and has an external sovereign rating of "A" or higher, as shown in the following graph.

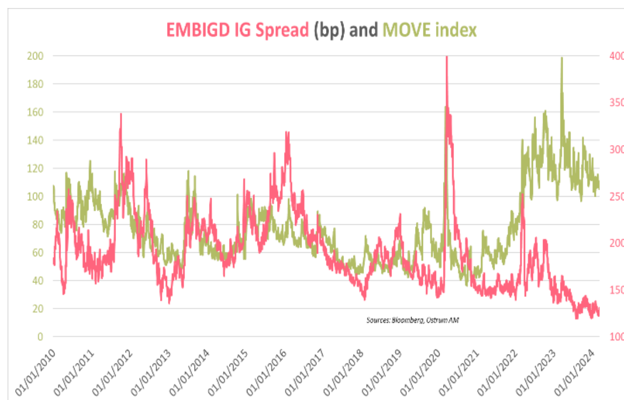


30% of the JPM External Debt Index now has an excellent sovereign rating of 'A' to 'AA'. This rate was only 8% in 2013. The inclusion of the Gulf countries has therefore helped to improve the credit profile of IG external sovereign debt.

However, the improvement of macroeconomic fundamentals also explains this resilience, particularly on fiscal metrics. Public debt in these countries is still below 60% of GDP, while public debt in developed countries is above 100% of GDP. Their external vulnerability has also been significantly reduced, notably due to inflows of foreign direct investment, reflecting the integration of many countries into global value chains.

… Allowing decoupling

The improved credit profile of IG external sovereign debt explains its resilience during the Fed's policy rate hike phase. The chart below shows the JPM EMBIGD IG spread and the MOVE volatility index on the US sovereign bond market.



There is a stall between the two indices over the recent period. Volatility in the US sovereign bond market remains high, while the risk premium on IG external sovereign debt has fallen significantly to 130 bps, a lower level since 2010, reflecting the decoupling of the asset class from the environment of international interest rates, particularly US.

Conclusion

The maturity of EM IG sovereign hard currency debt is no longer a matter of debate. Its resilience reflects a marked improvement in macroeconomic fundamentals, including low debt levels, combined with a good sovereign rating. The improved credit profile allows the EMBIGD IG spread to be in line with its counterpart on US IG-rated companies. Emerging-market central banks, which were

the first to raise their policy rates, are now reaping the benefits by easing their monetary policy before those of the main monetary places. This is positive for emerging sovereign debt.

Zouhoure Bousbih

Market review

The confidence game

The confidence of central bankers in the continuation of disinflation, rather than the data, will determine the date of the first rate cut.

Christine Lagarde and Jerome Powell are looking for every reason to lower their interest rates. It is now a matter of being sufficiently “confident” in the disinflation process, even though inflation is still subject to significant upward risks. In the euro area, wage growth inertia, the gradual withdrawal of cost-of-living government measures and signs of recovery seem to contradict the sharp downward revision of the ECB's inflation forecast for 2024: 2.3% compared to 2.7% forecasted in December 2023 and 3.2% in September 2023. Furthermore, the ECB will soon unveil a review of its operational framework. In the United States, the expected monetary relief will undoubtedly spur housing price inflation. The “confidence” game played by central bankers is therefore a bet on price stability, to which the market is visibly buying in. The decline in long-term interest rates sparked an immediate rally in equity indices and CDS markets. Sovereign spreads keep tightening, even ignoring the bad news on the fiscal side. That said, the reaction of the cash corporate credit markets was more measured. Expected monetary easing contributed to a weaker dollar, whilst fueling the rush into risky assets. The long-awaited rebound in the Japanese yen foreshadows an end to the negative interest rate policy as wage data came in stronger than anticipated.

US GDP growth should hover around its potential at 2% in the 1st quarter. The labor market is normalizing with a lower quits rate. Job creation remains upbeat at 265k on average over the past 3 months. There are numerous announcements of layoff plans but weekly jobless claims remain very low overall, between 200k and 220k. Household income and wealth continue to increase, providing a basis for strong spending growth. Meanwhile, business spending on structures and equipment is improving. In the euro area, surveys predict a resumption of activity driven by southern European countries. Private consumption, which is still very weak (+0.1% in the 4th quarter), must be the driving force thanks to the recovery in real wages.

The dovish message from central banks continues to dictate market performance. The absence of volatility (across equities, credit and currencies) thus indicates that market participants buy into the scenario of growth without inflation that monetary authorities aim for. The US 10-year note yield fell below 4.10% as breakeven inflation rates declined. The Bund follows a similar trajectory below 2.30 %. Yield curve flattening is beneficial to all risky assets. The swap spread has stabilized around 35 bp. The valuations of core government bonds (DSL, RFGB, OAT) represent attractive value against swap. The outperformance of Italian BTPs continues as 10-year spread reaches 130 bp, i.e. the levels that prevailed before the Ukrainian crisis. The 2 pp upward revision in the 2023 fiscal deficit hardly affected investor confidence. Portuguese debt (65 bp) was also tightening in the run-up to the elections. In the United Kingdom, the government is using its meager fiscal room for maneuver (2 pp reduction in social contributions) to reduce a 20 pp gap in voting intentions for the elections to be held in the autumn. Fiscal relief means higher Gilt issuance by £7bn during the financial year. The 10-year Gilt hovers around 4%.

The favorable trend is fading in the credit market. Spreads have widened by 5 bp since the low point of 82 bps on February 26, in line with selling pressure recorded on the main ETFs in the asset class. The iTraxx Crossover very quickly plunged below the 300-bp threshold like stock futures.

The rise in the Nasdaq masks major outflows from US technology stocks, according to BofA. Positioning through short-term option markets may be a better directional indicator than final flows. In addition, the regular attrition of the equity market through share buyback plans also pushes up stock prices and perhaps spark a FOMO effect (the Fear Of Missing Out on a rally). In Europe, share buybacks will total €200 billion, or a third of the return to the shareholder. Final investors participate little in the rally.

Finally, the dollar depreciated mainly against the Japanese yen which is finally moving away from 150 against the greenback. In turn, the euro picked up to $1.09.

Axel Botte

Main market indicators

G4 Government Bonds	11-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.8%	-11	+8	+39
EUR Bunds 10y	2.28%	-11	-10	+26
EUR Bunds 2s10s	-51.4bp	0	-18	-13
USD Treasuries 2y	4.51%	-9	+3	+26
USD Treasuries 10y	4.08%	-13	-10	+20
USD Treasuries 2s10s	-43.6bp	-5	-13	-6
GBP Gilt 10y	3.96%	-16	-13	+42
JPY JGB 10y	0.76%	+4	-13	-25
€ Sovereign Spreads (10y)	**11-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	46bp	-1	-2	-8
Italy	132bp	-9	-11	-35
Spain	82bp	-5	-5	-14
Inflation Break-evens (10y)	**11-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.17%	-6	-2	+4
USD 10y Inflation Swap	2.47%	-7	+1	+6
GBP 10y Inflation Swap	3.58%	-7	+1	+4
EUR Credit Indices	**11-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	120bp	-1	-11	-18
EUR Agencies OAS	61bp	-2	-6	-9
EUR Securitized - Covered OAS	67bp	-2	-8	-12
EUR Pan-European High Yield OAS	357bp	+6	+1	-42
EUR/USD CDS Indices 5y	**11-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	52bp	-2	-5	-6
iTraxx Crossover	295bp	-4	-21	-18
CDX IG	50bp	-1	-3	-7
CDX High Yield	330bp	-1	-13	-26
Emerging Markets	**11-Mar-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	366bp	-3	-24	-18
Currencies	**11-Mar-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.093	0.654	1.439	-1.0
GBP/USD	$1.283	1.072	1.576	0.8
USD/JPY	JPY 147	2.506	1.702	-4.0
Commodity Futures	**11-Mar-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$81.4	-$1.4	-$0.2	6.0
Gold	$2 183.6	$69.1	$163.5	5.8
Equity Market Indices	**11-Mar-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 114	-0.34	1.73	7.2
EuroStoxx 50	4 934	0.43	4.63	9.1
CAC 40	8 023	0.84	4.91	6.4
Nikkei 225	38 820	-3.21	5.21	16.0
Shanghai Composite	3 068	0.96	7.07	3.1
VIX - Implied Volatility Index	15.63	15.86	20.88	25.5

Source: Bloomberg, Ostrum AM

Additional notes

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