MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 094 // **December 12, 2022**

Topic of the week: Clash of Empires: new regime for Asset Allocation

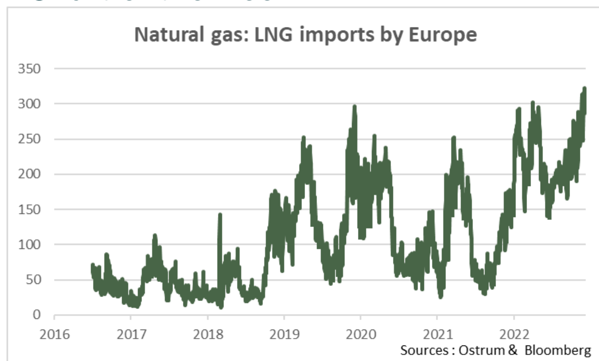
- **The peak of globalization could be reached, calling into question the disinflationary trend of the last thirty years;**
- **Diversification no longer works under high inflation;**
- **Conventional approaches to multi-asset class management can expect a return to historic norms;**
- **However, such expectations are difficult to maintain when volatilities, correlations and the very notion of "risk-free" assets evolve to adapt to structural changes;**
- **Investors must adapt to changing correlations in a changing world.**

BREAK: this is the last *MyStrat* of the year, we are on break until the beginning of next year. All the team wishes you a great holiday season.

Market review: ECB QT awaited by markets

- **ECB will unveil its QT plan**
- **TLTRO: 447 billion to be paid back to ECB**
- **Breakeven inflation rates fall on oil price slump**
- **Credit spreads resist to equity market weakness**

Chart of the week



The European economy is showing good resilience to the energy crisis for now. The projected recession is still not there, Q3 growth was 0.3%, and the most recent figures are ambiguous on Q4, suggesting growth very close to zero. The energy crisis is obviously a problem for growth but the crisis is much less serious than feared.

One of the reasons is in the graph opposite, alternative sources have been developed, in particular the imports of liquefied gas which have greatly increased and allowed (in part only!) to level off the decline of Russia's importations.

Figure of the week

20

On the first of January, Croatia will join the Eurozone and adopt the common currency. It will be the 20th country to join the Euro.

Source : Ostrum AM

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Topic of the week

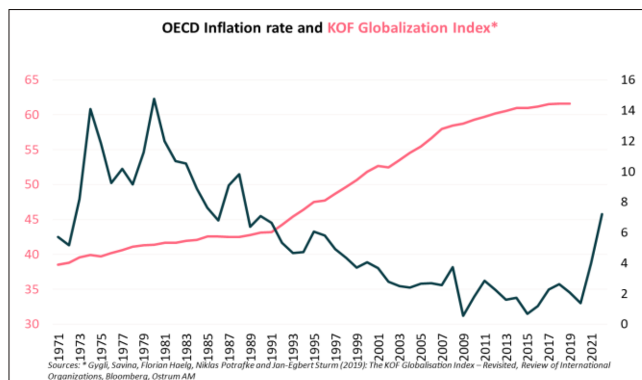
Clash of Empires: new regime for Asset Allocation

For the first time since the World War II, the United States are confronted with powerful and aggressive opponents, who want to increase their sphere of influence and demand territories, like the Russians with the invasion of Ukraine. This is a major structural shift in globalization as it has been so far. The shock on commodity prices has revived inflation in the major monetary places, disrupting the assumptions of asset allocation.

Towards secular inflation?

The peak of globalization could be reached

Among the factors that explain the downward trend in inflation observed over the past thirty years, globalization, particularly China's entry into the World Trade Organization in 2001, has been the main catalyst. Indeed, the accession of China (but also of India and other emerging countries) has led to a decrease in production costs at world level, making the price of imported goods less expensive. Companies have been able to access cheap labor and resources in these countries.



Sources: * Gygli, Savina, Florian Haelg, Niklas Potrafke and Jan-Egbert Sturm (2019): The KOF Globalisation Index – Revisited, Review of International Organizations, Bloomberg, Ostrum AM

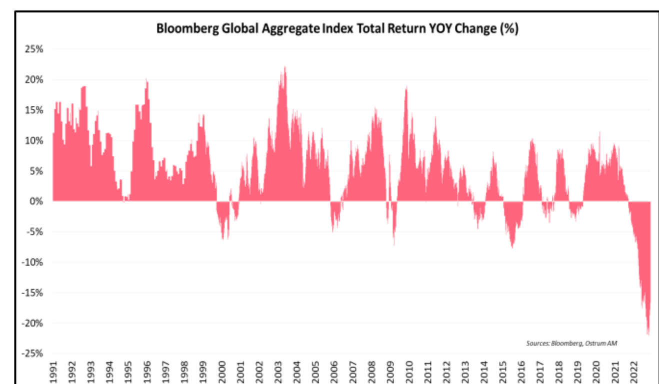
This trend could be reversed because of the increasingly unpredictable and frontal rivalry between the United States and its rivals. Indeed, the previous period of globalization had been characterized by a lack of clash between major powers, which had allowed inflation to remain at low levels for a long time. Xi Jinping now has full power in China and seems to put his ideology ahead of his country's economic boom. His statement at the 20th Congress of the Chinese Communist Party speaks volumes about his intentions. The Chinese President said he was "ready to fight (with the United States) and pay the price". Xi Jinping's response to his American rival is therefore unambiguous. On the other hand, China's growing economic self-sufficiency risks slowing the pace of globalization, which can be exacerbated by political pressures from populist and nationalist movements in developed countries. The risk is then a return to protectionism, which would lead to a sustainable rise in consumer prices.

Green transition creates new geopolitical challenges

The war in Ukraine has also accelerated the green transition, which is also inflationary in nature because it requires rare earths, a major new geopolitical issue, of which China is the main producer (80% of world production) and supplier. Other countries are also producers, such as the Democratic Republic of Congo, which is the world's largest producer of cobalt (70% of world production), an ore used to increase the storage capacity of electric batteries. The idea of a kind of OPEC rare earth has even been raised, which would put upward pressure on prices. It is therefore not possible to exclude other geopolitical shocks linked to the monopolization of these rare earths by the emergence of new powers.

R.I.P "Bull Bond Market"?

This trend deceleration in inflation (as well as monetary policy), particularly in developed countries, had resulted in persistently low interest rates: the famous "Bull bond market". This year, investors experienced their first "Bear bond market" on fixed-rate bond assets in 40 years, reflecting the -20% GA recorded by the Bloomberg Global Aggregate Index, as shown in the chart below.



Sources: Bloomberg, Ostrum AM

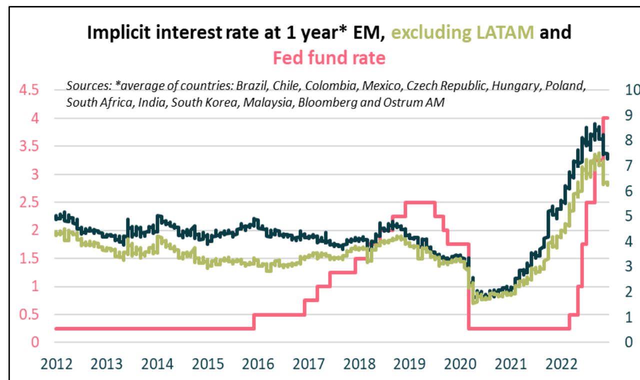
The main reason for this is the acceleration of inflation linked to the commodity price shock resulting from the war in Ukraine. Is there a change in the trend on the interest rates of the major monetary places, which would result in

persistently high interest rates? The answer lies with the central banks.

What about the Central Banks?

The remark of Ilan Goldfajn, former governor of the Brazilian Central Bank (recently appointed president of the Inter-American Development Bank) is relevant to understanding the difficulties facing the Central Banks of major money markets.

According to I. Goldfajn, developed country models consider 25 years of history during which inflation was close to 2%. The data that feed the models therefore give a response that leads the central banks of developed countries to complacency with inflation. On the contrary, he takes the example of Latin America, which also has significant inflation models, but which knows from experience that when inflation exceeds the 5% rate, it is dangerous. Indeed, since March 2021, Latin American central banks have been aggressively raising interest rates for the first time before the Fed, as shown in the chart below.



Rising commodity prices have helped producer countries to mitigate the impact of the monetary tightening on their growth.

On the other hand, if inflation becomes secular, the central banks' favorite tool to fight inflation, interest rates, is questionable. High borrowing costs are unnecessary in the face of supply and demand imbalances resulting from a more complicated geopolitical environment. A new inflation target is likely to be set to consider the complexity of the current geopolitical environment. For now, the 2% target should be maintained so as not to add uncertainty.

Shift of regime for asset allocation

Conventional approaches to multi-asset management can expect a return to historical norms. However, such expectations are difficult to meet when the volatilities, correlations and the notion of "risk-free" assets are evolving to adapt to structural changes such as the possibility of a trend acceleration in inflation due to rising geopolitical pressures.

Inflation is the main determinant of the structure of correlations…

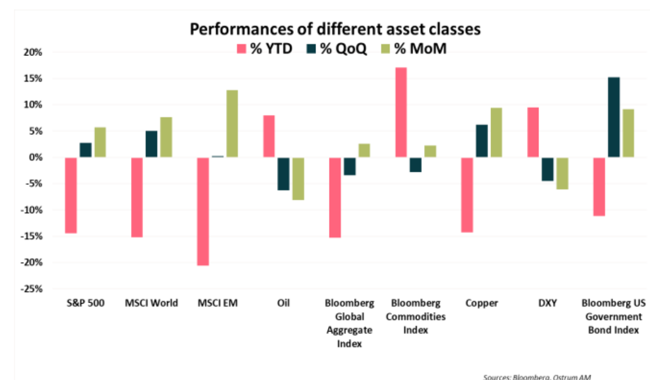
In times of high geopolitical uncertainty, the "Flight to Quality" benefits government bonds. The table below shows the performance of the American and European stock market indices, as well as their government bonds, during the four periods of major contemporary international conflicts.

Returns during reaction to geopolitic event	S&P 500	US 10 Y interest rate	Euro Stoxx 50	Germany 10 Y interest rate
Gulf war (August 2 1990- February 28 1991)	-20.0%	16.4%	-25.4%	11.2%
11 September (September 11-October 2001)	-12.6%	7.5%	-20.3%	11.3%
Irak Invasion (March 10 2003-May 1 2003)	-12.9%	15.2%	-21.8%	12.4%
Crimea Crisis (February 20-March 28 2014)	-2.2%	7.2%	-5.3%	10.0%

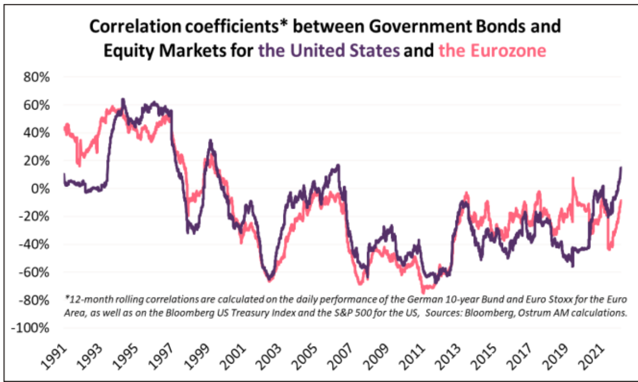
Sources: Bloomberg,Ostrum AM

Diversification between government bonds and equities thus played its role during periods of geopolitical tensions. However, the war in Ukraine has upset the assumptions of asset allocation, including diversification.

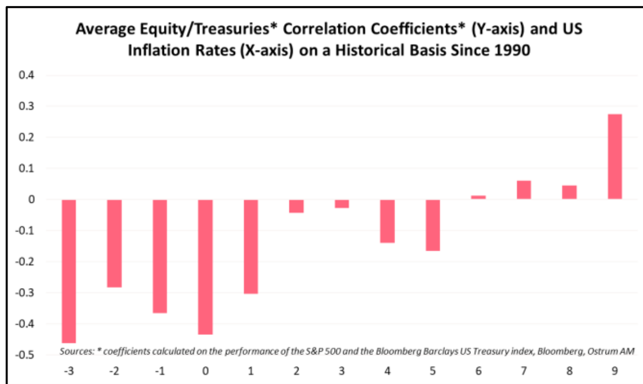
The graph below shows the performance of several asset classes on different frequencies.



Since the beginning of the year, all asset classes have recorded negative performances except for the dollar and commodities. Diversification has therefore not been able to protect the famous 60/40 portfolio, a pillar of the long-term investment strategy. This is due to a change in the regime of traditional correlations, notably that between interest rates and equities, as shown in the next chart.



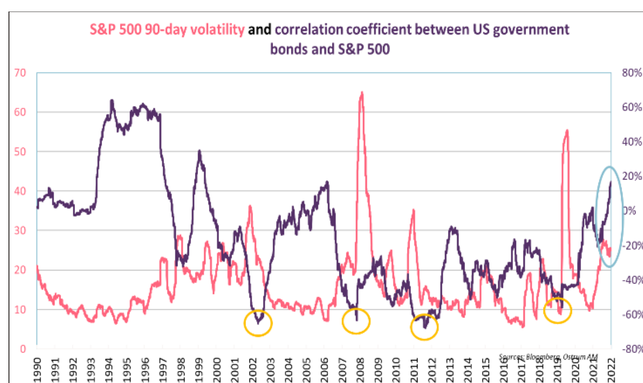
After two decades of negative correlation between equities and rates, it has become positive since the beginning of the year, in the United States but also in the Eurozone. The chart below shows the correlation coefficient between US equities and government bonds as a function of the inflation rate.



Government bonds provide protection for equities when inflation is low, below the 2% target. However, when the inflation rate accelerates strongly, exceeding the 6% rate, government bonds are no longer a hedge for equities.

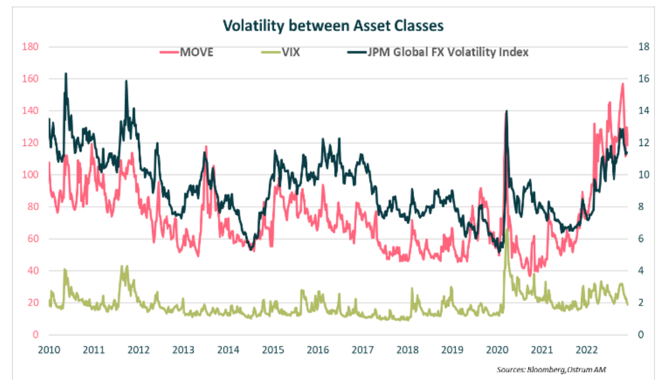
… As well as volatility

The chart below shows that the correlation between government bonds and equities is most negative during periods of high volatility.



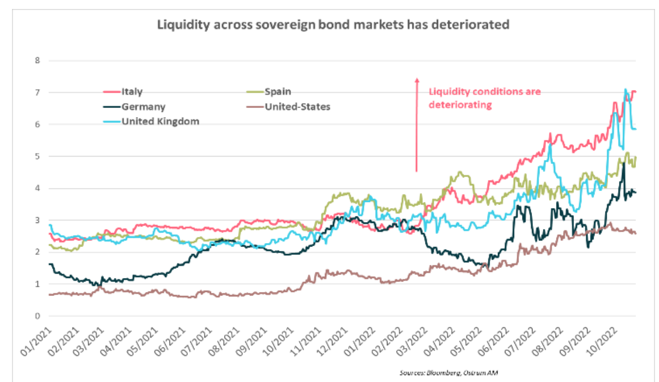
This result is consistent with the flight to quality usually observed in times of strong risk aversion, benefiting government bonds at the expense of risky assets. However, on the recent peak of volatility, the correlation was positive.

The models used in asset allocation are calibrated on historical distributions of returns that do not take into account the conditions of financial market volatility. As the correlation between equities and rates increases, losses in a diversified portfolio can be higher than expected, triggering portfolio readjustment movements that contribute to increased volatility on financial assets. This could explain the increase in volatility observed between asset classes since the beginning of the year. The chart below shows volatility on US government bonds (MOVE Index), US equities (VIX) and the foreign exchange market (JP Morgan Index).



Challenging the concept of "risk-free" assets: the example of British pension funds

Portfolio readjustment movements can be brutal, damaging liquidity in the sovereign bond markets of major money markets, as shown in the chart below.



The most telling example is the liquidity problems experienced by British pension funds following the announcement of the "mini-budget" at the end of September (the author also invites you to read *MyStratWeekly* of November 24 entitled «Volatility on the Gilt and stress on pension funds»). The loss of credibility of British economic policy among investors had resulted in massive sales of gilts

forcing the BoE to relaunch its QE, to intervene as a buyer of last resort. However, this episode brought to light that the notion of “risk-free” assets could be questioned, as well as the liquidity risk for pension funds. It should also be thought-provoking for governments that want to move from a pay-as-you-go pension to a funded pension.

Adapt!

Ultimately, government borrowing from developed countries will once again become “safe” assets once the inflation problem is fully resolved, which will take time. The visibility on the end of the war in Ukraine is very limited, making the issue of energy supply persistent, especially for European countries and the United Kingdom.
On the other hand, visibility is better in other markets, such as emerging markets that offer yield opportunities. Real rates are attractive in Brazil, and even in Hungary despite political uncertainties. The implicit yield of the one-month exchange contracts of the Hungarian forint is 16%, exceeding 12% for the Brazilian real! In China, the absence of inflationary pressures provides room for monetary policy to boost growth following the end of strict mobility restrictions linked to the zero-Covid policy. Xi Jinping’s challenge is now to restore Chinese consumer confidence after nearly three years of strict lockdown. The Chinese authorities will have no choice but to work hard to reach their 5% growth target in 2023. The MSCI China/MSCI World ratio is at its lowest level since 2000, as shown in the chart following, which also offers opportunities in the Chinese equity market.

Conclusion

Globalization as we have known it is currently experiencing a reversal that has led to a significant structural change at the global level: the risk of a trend acceleration of inflation. This upsets all the assumptions of asset allocation: the famous 60/40 long-term investment portfolio, pairs of traditional correlations, and even the notion of "risk-free" assets. The investor therefore faces an underestimation of risk which increases the risk of a sudden adjustment of his portfolio. Relying on historically normal correlation and volatility patterns no longer protect a diversified portfolio. The investor must consider its changing correlations, reflecting a changing world, and adapt by increasing its diversification to other markets.

Zouhoure Bousbih

Market review

ECB QT awaited by markets

TLTRO prepayments accelerate ahead of ECB communication on QT, Fed dots to move markets

It is that time of the year when balance sheet window dressing trades come into play as year-end closing looms. Market depth is still deteriorating as year-end holidays approach. Nevertheless, the meetings of the central banks in mid-December are likely to bring volatility back one last time in 2022. The ECB should unveil its quantitative tightening strategy as it relates to the interest rate policy and the reimbursement of TLTROs. The Fed will chart a new path for Fed funds in 2023 and beyond as financial conditions have largely eased for the past month and a half. Inflation is decelerating faster than expected thanks to the sharp drop in oil, which is trading around $71 on the WTI. Break-even inflation rates are logically pointing down. Long-term yields remain under pressure with yield curves all the more inverted. The T-note thus capped around 3.55% with a 2-10 year spread near -80 bp. The 10-year Bund is trading around 1.85% at the end of the week. Sovereign spreads remain at relatively tight levels whilst credit spreads keep narrowing. The further easing of swap spreads is finally benefiting covered bonds that have been lagging behind for a month. On the other hand, high yield spreads widened in Europe and the United States by nearly 10 bp.

The ECB meets on Thursday 15 December. A 50 bp rate hike bringing the deposit rate to 2% seems certain. The uncertainty relates more to balance sheet policy and the mix with a variety of monetary policy instruments. The reimbursement of TLTROs accelerated last week. The prepaid total amounted to €447 billion, which is added to the first flow of €296 billion. The residual outstanding has shrunk from €2,217 billion at its peak in June 2021 to €1,373 billion now. The doves of the ECB will see in this contraction of the balance sheet (admittedly at the initiative of the banks) an argument to delay the amortization of the APP. Similar to Fed policy, the ECB QT may be limited to a fixed amount each month. Bond maturities in 2023 represent approximately 1% of current APP holdings. In addition, the flexibility of the PEPP will be maintained to manage risks to financial stability. PEPP data for October and November shows that the ECB bought vast amounts of Bunds at the expense of peripheral sovereign debt, effectively rebalancing the flows implemented at the start of the summer. Surprisingly, the same movement favorable to German Bunds can be seen on the November flows on the APP. The non-reinvestment of debt holdings from Austria undoubtedly played a role in the widening of core debt spreads (Finland against France for example). Given the January issuance calendar and expected rate hikes through next spring, APP QT could start in April. The Fed's task seems simpler at first sight but Powell struggles to convince market participants that further tightening is needed. Inflation will fall, but a return to 2% remains hypothetical given the inertia of service price inflation, tensions on food prices (+3.7%m in November in the food PPI) and persistent imbalances in the labor market. Interest rate forecasts will probably be raised at the next FOMC, which should validate the expected 50bp hike. Meanwhile, the BoC raised its repo rate by 50bp while communicating its intention to study the need for further adjustments. A final 25bp hike is expected in January.

The inversion of the US yield curve remains very significant. The 2-10 year spread at -80 bp reflects the demand for long-term duration in line with expectations of lower inflation. The US Treasury’s refinancing strategy also influences the shape of the yield curve. If the bulk of the 2023 financing comes from an increase in the outstanding amount of bills, the need for long-term financing would only be reduced and mainly a function of the QT of the Fed, and therefore easily predictable and likely to reduce the risk associated with a long position. In the euro area, long-term yields are also below that on than 2-year bonds. The increase in the deposit rate should put a floor on long-dated bond yields. The Bund is nevertheless trading below 2%, despite the imminence of the deposit rate hike. The early repayment of TLTRO and the expected QT will likely facilitate a gradual normalization of this negative carry situation. Sovereign spreads seem insensitive to announced fiscal expansions. Liquid markets are favored over small core sovereigns (Austria, Finland) which have widened towards French spreads. Belgian debt spreads are also rising. This arguably offers relative value opportunities over the coming months.

In corporate credit markets, the narrowing of spreads continues. Valuations have normalized with an average euro IG spread of around 174bp against Bund. The primary market slowed after strong activity in November. Issuers took advantage of the easing in spreads and inflows into credit funds to sell new debt securities. High yield, on the other hand, is trading weaker. The market momentum is for spread decompression as credit investors take profits on protection selling on the iTraxx crossover. To a degree, the market is taking a breather.

US stocks are seeing buybacks for the third week in a row. New York market indices lost between 2 and 4% over the week. The balance of flows remains unfavorable in Europe. The indices are down 1% despite gains recorded by the basic resources sectors. Energy stocks took a hit from excess oil supply.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	12-Dec-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.16%	+4	-5	+278
EUR Bunds 10y	1.92%	+4	-24	+210
EUR Bunds 2s10s	-24.7bp	+0	-19	-68
USD Treasuries 2y	4.33%	-6	0	+360
USD Treasuries 10y	3.54%	-3	-27	+203
USD Treasuries 2s10s	-78.8bp	+3	-26	-156
GBP Gilt 10y	3.18%	+3	-28	+221
JPY JGB 10y	0.25%	0	+18	+14
€ Sovereign Spreads (10y)	12-Dec-22	1wk (bp)	1m (bp)	2022 (bp)
France	46.47bp	+3	-1	+9
Italy	189.53bp	+3	-5	+54
Spain	102.01bp	+3	+1	+28
Inflation Break-evens (10y)	12-Dec-22	1wk (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2.6%	-3	-4	+54
USD 10y Inflation Swap	2.57%	-13	-13	-20
GBP 10y Inflation Swap	3.74%	-10	-50	-44
EUR Credit Indices	12-Dec-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	174bp	-3	-37	+79
EUR Agencies OAS	81bp	-1	-4	+32
EUR Securitized - Covered OAS	89bp	-1	-3	+43
EUR Pan-European High Yield OAS	535bp	+12	-54	+217
EUR/USD CDS Indices 5y	12-Dec-22	1wk (bp)	1m (bp)	2022 (bp)
iTraxx IG	90bp	+0	-6	+42
iTraxx Crossover	460bp	+4	-18	+217
CDX IG	80bp	+0	-2	+31
CDX High Yield	480bp	+1	-6	+187
Emerging Markets	12-Dec-22	1wk (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	455bp	-7	-61	+86
Currencies	12-Dec-22	1wk (%)	1m (%)	2022 (%)
EUR/USD	$1.053	0.334	1.927	-7.4
GBP/USD	$1.226	0.566	4.279	-9.4
USD/JPY	JPY 137	0.044	2.341	-15.8
Commodity Futures	12-Dec-22	-1wk ($)	-1m ($)	2022 (%)
Crude Brent	$76.4	-$6.3	-$18.0	5.49
Gold	$1 791.8	$23.1	$20.4	-2.05
Equity Market Indices	12-Dec-22	-1wk (%)	-1m (%)	2022 (%)
S&P 500	3 934	-3.37	-1.47	-17.5
EuroStoxx 50	3 943	-0.89	1.92	-8.3
CAC 40	6 678	-0.96	1.26	-6.6
Nikkei 225	27 842	0.08	-1.49	-3.3
Shanghai Composite	3 179	-1.02	2.97	-12.7
VIX - Implied Volatility Index	22.83	19.78	1.38	32.6

Source: Bloomberg, Ostrum AM

Additional notes

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