MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 060 // **March 7, 2022**

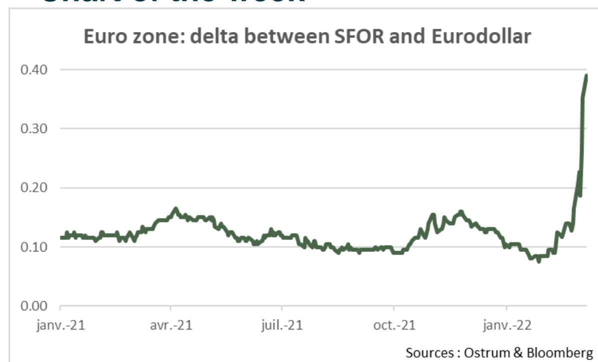
Topic of the week: Ukrainian crisis and monetary policy

- **The impact of the Ukrainian crisis will include both lower growth and higher inflation;**
- **A situation that creates a difficult dilemma for central banks torn between the need to support business and the desire not to let inflation get out of control;**
- **At the time of writing, the tightening trend is not in question;**
- **The crisis will have several consequences: a likely slowdown in the monetary tightening, especially in Europe, and therefore a more marked decoupling of the Fed and ECB. Inflation levels leave little room for maneuver to the ECB, activity, if it is to be sustained, will certainly be sustained by a budgetary effort.**

Market review: The war premium

- **The attack on a nuclear power plant can be a turning point;**
- **Real yields plummet amid flight-to-safety;**
- **Fund outflows accelerate in equity space;**
- **Swap spreads widen out in signs of interbank tensions.**

Chart of the week



A consequence of the current crisis is the tensions on the money market. The chart shows that dislocation are very important in Europe.

The situation is not much better in the US where tensions on the money market are also becoming obvious.

This is yet another challenge for the ECB and the Fed. The disruption of the money market could be very detrimental for the other financial markets. The good news is that central banks have the tool to address the issue. They will have to intervene more in the short term.

Figure of the week

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Source : Ostrum AM

According to the FAO, there are 813 million people in "severe food insecurity" in the world. In addition, 684 million people are "undernourished".
The surge in agricultural prices will be disastrous.

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● **Topic of the week**

Ukrainian crisis and monetary policy

While it is very illusory to quantify precisely the impact of the Ukrainian crisis on the economy, it is clear that the future trajectory will include both less growth at half-mast and more inflation. A situation that creates a difficult dilemma for central banks, torn between the need to support activity and the will not to leave inflation out of control. For the moment, the tightening trend is not being questioned, even if a pause or postponement is likely.

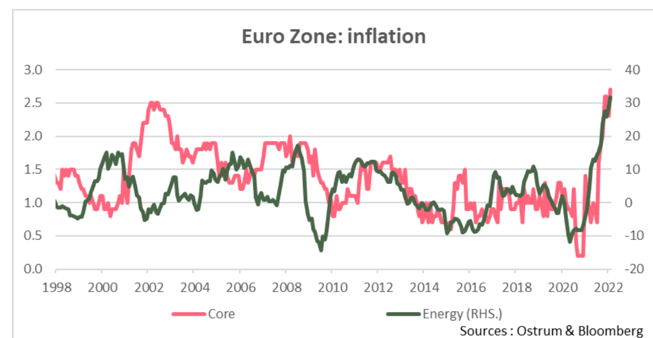
The dilemma: growth and inflation

The current situation is the worst possible from a monetary policy point of view. The Ukrainian crisis is a major shock to growth. Economic sanctions on Russia will inevitably have effects on other countries, shortages multiply (BMW has reduced the production of some models because the spare parts from its Ukrainian supplier are no longer arriving, EADS has titanium stock problems, Michelin does not have all the required raw materials, etc.) and rising prices have a negative effect on household income. According to our calculations (see chart below) real wages are down 3.5% year-on-year.

This undoubtedly calls for a policy of support for activity.

On the other hand, inflationary pressures continue to rise sharply. The latest published figures, which do not yet reflect the effects of the Ukrainian crisis, have surprised the upside. Once again. The very rapid rise in commodity prices leaves little doubt about the future trajectory of inflation, which should continue to rise.

Of course, a central bank is not supposed to react to the rise in commodity prices. Paradoxically, the effect of an increase in raw materials is recessive: without an increase in wages, an increase in raw materials acts as a deduction of disposable income, and therefore decreases demand. If the rise in raw materials thus creates, in accounting terms, a temporary rise in inflation, it also ultimately leads to impoverishment, and thus to deflationary pressures. The graph below shows that this mechanism was at work very clearly in Europe at least over the first ten years of the introduction of the Euro: underlying inflation was moving in the opposite direction to energy-related pressures. In this configuration, there is therefore no urgency to react for a central bank.



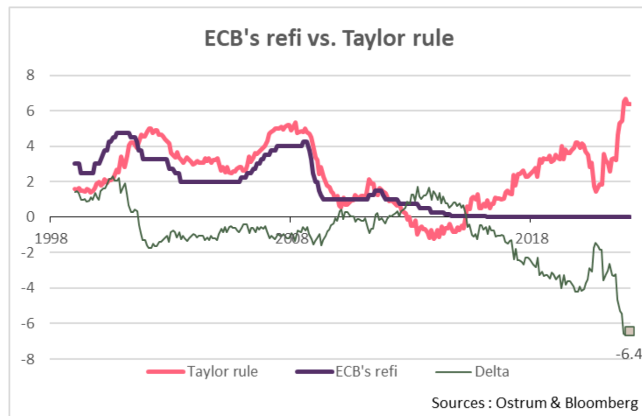
The problem of inflation, however, is twofold. On the one hand, the underlying level of inflation, that is, excluding raw materials, is also very high. More than two thirds of the components of the inflation index are above 2%. The second problem is that inflation expectations are beginning to take a worrying turn. In particular, market data show that expectations are less anchored around the ECB's 2% target. The risk then is that wages react and lead, not to impoverishment as we described above, but to a price/wage spiral.

> *The level of inflation is not the issue per se, the focus is on second round effects.*

This undoubtedly calls for a more restrictive policy.

Central banks in general and the ECB in particular are therefore in a very uncomfortable situation, torn between two extremes. The graph below illustrates this dilemma: with the current level of inflation and growth that has reduced the output gap, the ECB should have key interest rates close to 6%. Of course, this approach, if relevant over the first decade of the ECB, no longer is. However, it shows the major divergence between an extremely lax monetary policy

(on purpose!) and a very inflationary level of inflation.



A slowdown, not a U-turn

The past week on the markets has been instructive in terms of the trajectory of central banks.

First, the Bank of Canada raised its policy rates last week from 0.25% to 0.50%. This increase was expected, with all 27 economists responding to the survey agreeing. So the Ukrainian crisis has not changed the trajectory of the BoC at this time.

With respect to the Fed, J. Powell told us, "We expect a rate hike in March to be reasonable." Clear signal that the 25 bps increase due to March 16 is still very likely. In fact, Bullard, a voting Fed member, added, "The current policy exacerbates the inflation problem."

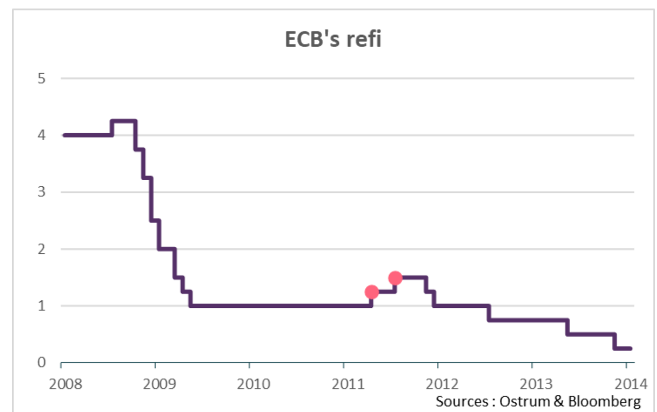
The markets have taken note. While the future Fed funds contract December-2022 had gained more than 25 bps, the markets had therefore removed a rate hike in their 2022 expectations. As the chart below shows, this increase was included again after Powell's intervention. The expected trajectory of the Fed is therefore almost the same now, as we write, as it was before the Ukrainian events.

For the time being, therefore, the trajectory of monetary policy tightening is not being questioned or even slowed in the case of the two central banks in North America.

Of course, this area is less at risk than Europe and so we should not extrapolate too simply to the ECB. Nevertheless, given the level of inflation, it is not absurd to think that the tightening trend is still the same.

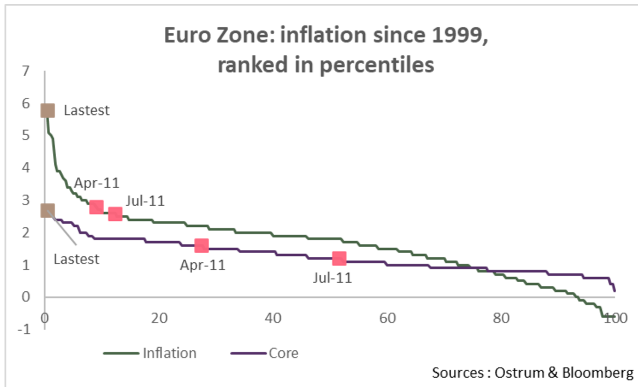
ECB and the 2011 mistake

Remaining on a monetary tightening for the ECB brings back old and bad memories: the two rate hikes of 2011, widely considered later as a monetary policy error. The ECB had indeed raised its key interest rates twice, from 1.00% to 1.25% on 7 April 2011, and from 1.25% to 1.50% on 7 July.

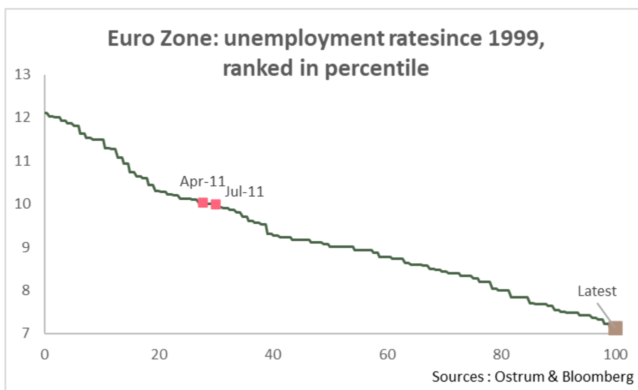


If the ECB maintained its desire to tighten up, there is a risk of repeating the "Trichet gaffe". The comparison, however, is partly wrong because the situation is very different.

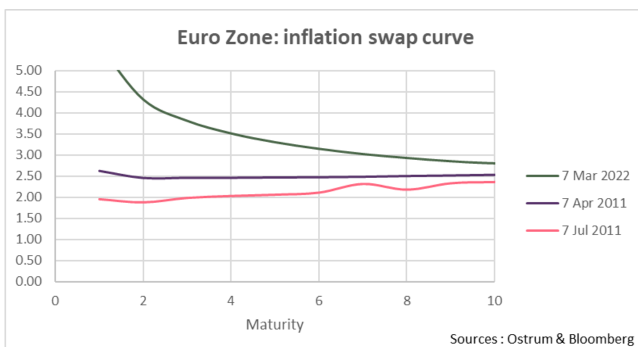
First in terms of inflation. The chart below shows that in 2011 inflation was a bit high (2.8% in April, 2.6% in July) but the underlying was much quieter, close to its median, and comfortably below 2% (1.6% and 1.2% respectively). So there really wasn't a disturbing signal on that dimension. At present, on the other hand, the figures are simply the highest ever recorded. And they are expected to increase further. So it's not the same situation at all.



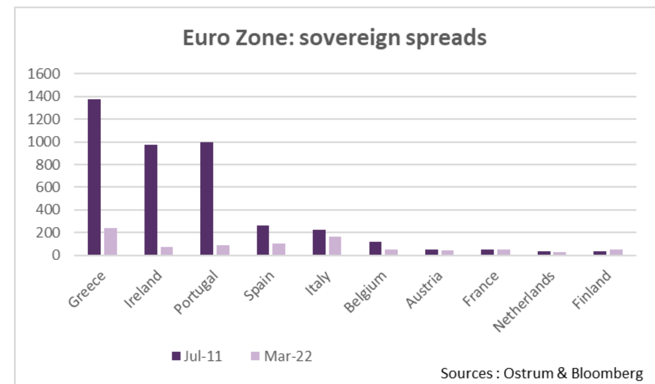
About unemployment, the same idea. When the rates went up in 2011, the unemployment rate was double-digit. Thus, there is little risk of tensions on the labour market or of wage risks. And a substantial output gap remained. In comparison, the current situation is incomparably more tense, again with an extreme figure since the unemployment rate is simply at an all-time low.



Finally, in terms of inflation expectations the situation has also changed. The situation in July 2011 showed a curve nicely aligned with 2% inflation for the following years. No worrying signs about expectations. The current curve on the other hand is obviously boosted on the short side by the latest very high figures, but the 5-year inflation rate remains on 2.9%. A figure far too high to be comfortable for the ECB. Here too, an additional upward shift in expectations would be a real problem for the ECB.



Finally, it should be remembered that the 2011 increases were made while the financial system, post Lehman, was already showing very worrying signs of weakness, in particular asset quality. The same applies to European states which were already clearly under pressure. The chart below shows the difference between the situation on the day of the rise on July 7, 2011 and Friday last week. Greek spreads were at 1.372 bps, they are more than 5 times lower at 243, Ireland was at 975, it is 14 times lower (!) to 69, Portugal was at 994 bps, it is more than 10 times lower at 91, Spain went from 265 to 103 and Italy from 220 to 160. The situation is undoubtedly very different.



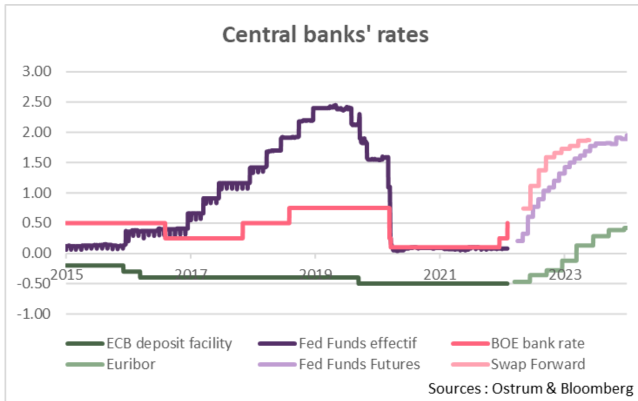
In summary, the 2011 spectrum is valid in that the ECB must hesitate between a risk of inflation and growth. However, the situation is very different.

Conclusion: decoupling and budgetary effort

How to reconcile fears about growth and the potential runaway of inflation? It seems clear to us that the ECB is on alert in terms of inflation. Not really because the inflation figures are high, they are driven by the rise in commodity prices, which ultimately has a recessionary effect. But rather because the pressures are becoming more widespread and the strong movement of expectations suggests that second-rate effects, particularly on wages, could appear. It then seems clear that the ECB, like the Fed or the Bank of Canada, remains on a trend of monetary tightening.

On the other hand, the growing risk that the Ukrainian conflict poses to growth should encourage prudence. It is urgent to wait. This argument is much less relevant in North America, less exposed to the effects of the conflict.

One of the first consequences is therefore that we have to wait for a decoupling of monetary policies, at least temporarily, between the Fed and the ECB.



The other important point is that monetary policy cannot do much in this crisis. The main responsibility will lie with fiscal policy, which is already being used to cushion the effect of energy price rises. Once again, we can expect budgets to deteriorate.

Stéphane Déo

Market review

The war premium

The attack on a nuclear power plant may mark the point of no return

The war situation in Ukraine completely dominates the news in the financial markets. Last Thursday, the fire at a Ukrainian power plant after a missile hit a facility raised fears of a nuclear accident sparking panic in Asian stock markets. The S&P 500 is down about 10% in 2022, the European equity indices lose more than double that amount. Raw materials' prices are flying. The price of copper exceeded $1,000 per ton given very low inventory levels (on the LME or in Shanghai) and expected supply disruption amid warfare in Ukraine. Wheat is also facing an unprecedented supply crisis with the war in Ukraine. Brent is close to $112. Despite the $9 discount to oil from the Urals and the withdrawal of foreign buyers, Vladimir Putin is largely profiting from the rise. Progress in negotiations with Iran on the nuclear issue and a lasting resumption of oil production in the United States will no doubt be necessary to stem the current rise in oil prices.

The nervousness of the financial markets naturally benefits traditional safe havens, foremost among which is the dollar. The dollar-yen seems inert so far around 115. An ounce of gold is trading above $1900. European swap spreads widen to 75bp on the 10-year Bund. The yield on the German bond is trading around 0%. Sovereign spreads, on the other hand, are spared. The T-note is trading at 1.80% with very high price variability (1.70% at the low of the week). However, the Fed persists and signs a 25bp rate hike in March. The CPI release next Thursday will likely confirm the need for a rate hike.

Growth in the United States seems little affected by the conflict despite the rise in the cost of energy. Sector surveys reflect a rebound in activity after a short-lived downturn linked to Omicron and the blockage of the Canadian bridge. The ISM manufacturing index came out at 58.6 in February, that of services nevertheless fell back to a 56.5 reading. Employment is growing solidly at the rate of 678k in February. Job data for December-January has been revised up by 92k and participation is increasing. Weekly jobless claims fell back to around 215k. The unemployment rate is at 3.8%. In the euro area, inflation jumped to 5.8% in February according to the flash estimate. The euro below $1.10, energy prices and rising food prices will keep consumer prices on an upward trend. The ECB meets on March 10 and is expected to confirm the QE exit timetable and the prospect of a rate hike at the end of the year.

On the financial markets, the war generates a retreat towards the asset deemed risk-free even if the currently high volatility of the T-note or the Bund may seem to contradict the very notion of a safe haven. The yield on T-bills has also turned negative again on some maturities. Bund yields plunged 30 bps last week. Tensions appear on short-dated spreads due to increasing the term premium or the interbank risk premium. The deterioration in swap spreads in the euro area above 80 bp on maturities of 2 to 10 years therefore reflects the search for security and the credit risk associated with the banking system and its actual or perceived exposure to Eastern Europe. Bank CDS are suffering. The premium of bank CDS (senior debt) over the iTraxx doubled compared to January-February to 16 bps. The liquidity situation does not seem (so far?) to be the main source of tension. The sharp fall in bond yields is mainly traceable to a decline in real yields. Inflation expectations exploded upwards (+37 bp on the euro 10-year swap over one week) after the publication of European inflation at 5.8% and core inflation at 2.9%. It is nevertheless difficult not to maintain a long duration bias, particularly in real rate space in both the euro area and the United States. At the same time, Chinese bond yields and the CNY represent a relative pole of stability thanks to the tight control of the markets by the PBoC. The yen also offers a decorrelation solution in portfolios.

Credit markets are obviously under pressure. Spreads are widening under the impetus of CDS indices used as portfolio hedges. The iTraxx index is trading around 85 bp at the end of the week. The broad market basis (cash-CDS spread) has thus become positive again, but the balance of flows is unfavorable and significant risks weigh on the markets. Issuers with exposure to Russia are hardly being traded but some primary market deals remain attractive and tighten in secondary markets thereafter. New issue premiums have improved amid heightened market volatility. This indicates that despite the outflows from credit funds, there is still demand for good quality debt, especially on short-term maturities. High yield funds are experiencing more outflows on both sides of the Atlantic. The iTraxx Crossover is approaching the 400bp threshold and total outflows from the euro asset class now reach 3.6% of fund assets in 2022. Appetite for leveraged loans, which have the advantage of being floating rate securities, is now reduced.

As for equities, war obviously has a large impact. European stock fund outflows totaled €7 billion, the largest outflow ever recorded over a week. The main European stock indices are down nearly 10% in just one week and the dominant investor sentiment is a form of capitulation, after the attack on the nuclear power plant in Ukraine.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	07-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.68%	-15	-39	-6
EUR Bunds 10y	-0.03%	-17	-26	+15
EUR Bunds 2s10s	64.3bp	-2	+13	+21
USD Treasuries 2y	1.51%	+8	+22	+78
USD Treasuries 10y	1.74%	-8	-17	+23
USD Treasuries 2s10s	23.4bp	-15	-39	-54
GBP Gilt 10y	1.28%	-13	-13	+31
JPY JGB 10y	0.15%	-5	+11	+6
€ Sovereign Spreads (10y)	**07-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	49.12bp	+2	+2	+12
Italy	160.7bp	+3	+3	+26
Spain	102.08bp	+4	+4	+28
Inflation Break-evens (10y)	**07-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.72%	+42	+73	+62
USD 10y Inflation Swap	2.97%	+8	+36	+20
GBP 10y Inflation Swap	4.77%	+23	+54	+60
EUR Credit Indices	**07-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	151bp	+13	+38	+56
EUR Agencies OAS	72bp	+13	+19	+23
EUR Securitized - Covered OAS	83bp	+18	+33	+37
EUR Pan-European High Yield OAS	465bp	+49	+97	+147
EUR/USD CDS Indices 5y	**07-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	85bp	+15	+19	+38
iTraxx Crossover	410bp	+67	+91	+168
CDX IG	75bp	+8	+10	+26
CDX High Yield	398bp	+38	+37	+105
Emerging Markets	**07-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	511bp	+81	+134	+143
Currencies	**07-Mar-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.088	-3.048	-4.938	-4.3
GBP/USD	$1.314	-2.101	-2.940	-2.9
USD/JPY	JPY 115	-0.226	-0.139	-0.2
Commodity Futures	**07-Mar-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$123.3	$25.3	$32.1	60.35
Gold	$1 982.9	$73.9	$162.4	8.40
Equity Market Indices	**07-Mar-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 289	-1.94	-4.34	-10.0
EuroStoxx 50	3 565	-9.16	-13.49	-17.1
CAC 40	6 063	-8.94	-13.50	-15.2
Nikkei 225	25 221	-4.92	-7.56	-12.4
Shanghai Composite	3 373	-2.58	-2.31	-7.3
VIX - Implied Volatility Index	33.47	11.01	46.41	94.4

Source: Bloomberg, Ostrum AM

Additional notes

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