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Market views and strategy

Ostrum ASSET MANAGEMENT

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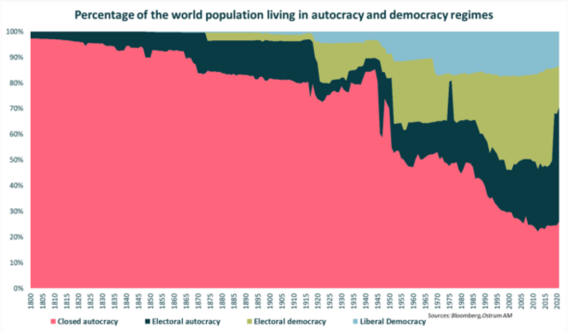
Topic of the week: When the ECB and the Fed lose (a lot of) money

- **The ECB, like the Fed, has a very large portfolio of government securities. With the rate hike this year, the value of this portfolio has fallen by several hundred billion, according to our estimates;**
- **Paradoxically, we think this is a minor problem;**
- **On the other hand, the rise in rates will have a significant impact on the level of profitability of the central banks, thus on their retrocession to the Treasury. And in terms of the cost of servicing the debt, it changes everything and creates an unprecedented rate sensitivity.**

Market review: Hoping for Fed pivot is dangerous wishful thinking

- **Short-term respite for markets at start of fourth quarter**
- **Fed officials reaffirm need for tighter policy**
- **OPEC cuts outputs by 2mbpd, adding to inflation worries**
- **Euro swap spreads under renewed pressure**

Chart of the week



Percentage of the world population living in autocracy and democracy regimes

Sources: Bloomberg,Ostrum AM

The trend over the last two centuries is very clear and very encouraging. Democracy has undoubtedly progressed, with more than a third of the world's population now living in countries with democratic political models.

A more precise view, unfortunately, gives a more worrying trend, over the past decade, the trend has reversed. Several countries have left the list of democracies, including Turkey and India

Figure of the week

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The range of the Bund last week, from 1.77 to 2.22%.

Source : Ostrum AM

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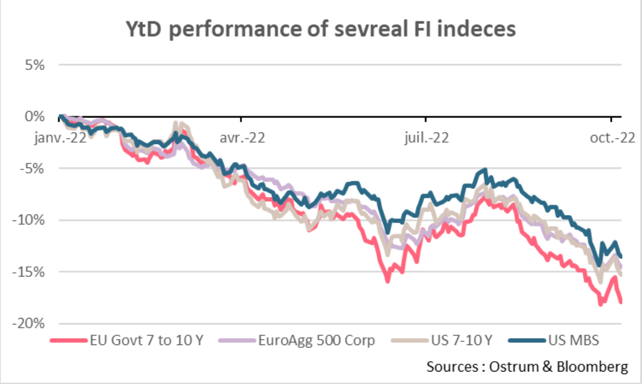
●Topic of the week

When the ECB and the Fed lose (a lot of) money

Both the ECB and the Fed have a very large portfolio of government securities. With the rate hike this year, the value of this portfolio has fallen by several hundred billion according to our estimates. But the real problem is rather on the operating account of the central banks, and therefore ultimately for the States, and for the trajectory of public finances.

The fall

Since the beginning of the year, a standard Eurozone sovereign portfolio has lost 17% of its value due to the rapid rise in interest rates. An equivalent portfolio of Treasury has lost 15% since the beginning of the year. For "risk-free" rates, this is a significant drop. If this performance is difficult for an investor, in the case of the two big central banks, which have accumulated a huge portfolio of sovereign papers with their QE, the amount of losses is in proportion.



Sources : Ostrum & Bloomberg

We will try to estimate the amount of these losses. Unfortunately, we don't have all the details to do a very specific job. But it is the order of magnitude that matters and for this the available information is largely sufficient.

The ECB

Let's start with the ECB. EQ portfolio data shows the following holding numbers:

- **Sovereign**: the PEPP portfolio was €1,661 billion at end-September, while the PSPP portfolio was €2,744 billion. That is a total of 4,405 billion.
- **Credit**: the contribution at end-September of the PEPP was low, of the order of 43 billion while the CSPP is 386 billion. That's a total of $429 billion. About a tenth of the sovereign portfolio.
- The ECB also has a portfolio of covered bonds but volumes are negligible for our year.

To estimate the valuation loss, we assume that the ECB's portfolio is identical to the composition of the "Bloom Barcl index. EU Govt 7 to 10 Year" and its equivalent "5 Years". The first index has lost 18% of its value since the beginning of the year, the second 9%. We weight these two indices according to the ECB's assets and our estimate of their residual maturity. Result, a total loss this year estimated at 550 billion euros.

For the credit portfolio we use the same approach. The "Bloom Barcl index. EuroAgg 500 Corporate" lost 14% of its Value since the beginning of the year, for a portfolio of 63 billion.

The ECB's total losses, in all probability, are therefore over 600 billion.

The ECB's sensitivity to interest rates can also be calculated. The DV01 is the change in the value of the portfolio for a change of 0.01%, or one basis point. In the case of the ECB, we estimate the DV01 to be in the order of 2.5 billion. In other words, every time rates rise by 0.01%, the ECB's portfolio depreciates by 2.5 billion.

The Fed:

In the case of the Fed it is possible to use the famous "SOMA" ("System Open Market Account Holdings of Domestic Securities").

- Treasury held $5,534 billion at the end of September.
- The holding of MBS amounted to 2,690 billion.
- Here we are neglecting the 312 billion T-Bills and other minor Fed account lines.

In the case of the Fed, we have all the lines of the portfolio and we can therefore estimate the losses on each security held. We arrive at a total loss of $675 billion. The DV01 for portfolio is in the order of $3.4 billion.

In addition to losses on SGM, the Bloomberg US Mortgage Backed Securities Index has lost 13.5% YTD. This would represent an estimated additional loss of $350 billion.

In total, the Fed would have lost around 1,035 billion.

		BCE (Bn EUR)	Fed (Bn USD)
Holdings	Sov	4405	5534
	Credit	429	
	MBS		2690
	TOTAL	4834	8223
Losses	Sov	-549	-678
	Other	-63	-350
	TOTAL	-612	-1028
Losses / Holdings		**-12.7%**	**-12.5%**

It's not so bad for central banks

Notional losses, which will not be realized

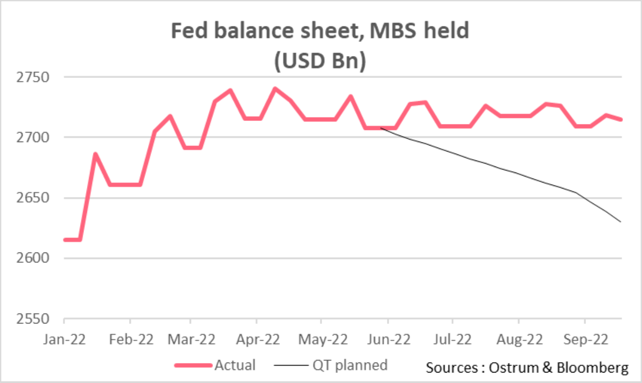
The estimates we have made are estimates precisely because they will not result in accounting entries. The securities held will be a priori up to maturity, and will therefore finally be repaid at par. The loss we have estimated is therefore theoretical.

Finally, central banks are very special, in the case of losses they can operate with negative capital. It's embarrassing, but it's obvious.

A potential issue for QT

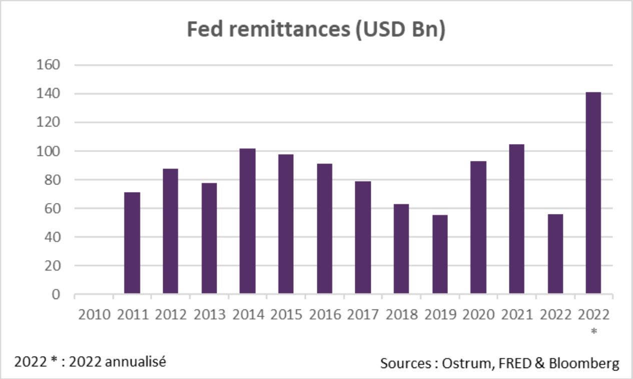
The accounting argument for securities valued at the purchase price nevertheless falls in the case of disposal of these securities. Let us imagine that a central bank bought a billion OAT at par, these OAT now rate 15% lower but they are valued accounting still at one billion. If there is a divestiture, however, it will be at the market price, 15% lower, and there will be a loss.

This is not really an issue for QT as much of it is done by the Fed by letting the securities mature. The ECB, if it implements a QT, will most likely use the same approach. But this is a problem for example for the Fed's MBS portfolio, few of which are reaching maturity. If they really want to reduce their MBS portfolio, then they have to sell and therefore realize a loss. Moreover, the implementation of the QT since June shows that the Fed is very far from its objective.



Sources : Ostrum & Bloomberg

If the Fed were to actually implement the announced MBS portfolio reduction, it would face a loss, which would reduce its annual profits. However, a large part of these profits are returned to the US treasury, the remittances as shown in the chart below. Explaining this to the congress will be a bit difficult.



2022 * : 2022 annualisé

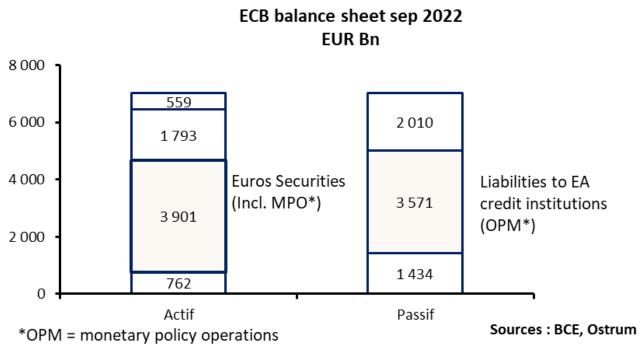
Sources : Ostrum, FRED & Bloomberg

The speed of reduction of the central banks' balance sheet is therefore very constrained. Again, this is an overcomable problem: the maturity of the sovereign securities held seems more than sufficient to fuel the pace of the envisaged QE.

But for the fiscal dynamic...

The last problem, more complicated and more serious, is for the state budget.

Let's take the case of the ECB with below in a very simplified way the balance sheet of the bank. The arguments developed, in essence, apply entirely to the Fed. De facto, the bank's liabilities are very short since a huge part of this liability consists of bank deposits of a monetary type. The cost of financing the ECB follows its key rates. On the other hand, a huge portion of the assets is made up of a buy-and-hold portfolio of long sovereign paper. Any ALM manager would be horrified by such an active/passive duration gap. But let's move on. The problem is that the profitability of this asset portfolio is largely fixed and depends on the level at which it is purchased, so a very low level (that was the objective: to have very low sovereign rates).



*OPM = monetary policy operations

Sources : BCE, Ostrum

In the end, this is therefore a problem for the ECB's result, profits will be lower and we can even imagine, if key interest rates go up to 3% as we think and as the market begins to anticipate, that the ECB will end up losing money.

The result, and this is the important point, is a problem for public finances. Take the case of the Banque de France to illustrate. First of all, when we say that the ECB does QE, in reality it is very largely Buba that buys Bund, the BdF that buys OAT, the Banca d'Italia BTP, etc… And so the securities of a country are held, to a large extent, by the central bank of that country.

With deposits paid at 0%, coupons paid on OAT held under QE inflated the BdF's profits. These profits are returned to the shareholder, the French Treasury. To simplify, the OATs held by the BdF were de facto zero-interest loans since (with a few subtleties we will spare here) all debt servicing was returned. With a higher cost of financing for the BdF, deposits are now remunerated at 0.75%, which will affect the BdF's profits. And so, here again by simplifying, the BdF will give back to the Treasury the coupon minus the financing cost, which is currently 0.75%. De facto, this 0.75% is now the cost of financing the French State for the part of the debt held by the BdF.

To sum up, about one third of the public debt is held by the ECB. The end result of QE is that this proportion of public debt held by the ECB has a cost that follows the ECB's key interest rate. We have just made this public debt a variable rate debt indexed on the ECB's key interest rate. The cost of financing States (French in our example, but also German, Italian, and… American) is therefore much more reactive to the rate than when it was financed with good old 10-year fixed rate OAT.

Conclusion

If the central banks, Fed and BCE in our article have theoretically lost huge amounts this year on their portfolio of securities, this is paradoxically a minor problem in our opinion. On the other hand, the rise in key interest rates has a direct impact on the financing costs of these central banks, which have mainly short deposits on their liabilities. On the asset side, however, the very low carry of the portfolio accumulated during QE does not change. And so the profitability of central banks will gradually erode. This is a problem for their shareholder, the States, which will therefore have less revenue. De facto, with key interest rates at zero, the government debt held under QE was perpetual debt (central banks bought back when it matured), at zero interest (coupons were returned). This debt is always perpetual (modulo the QT) but we see that its cost follows the key rates of the central banks. It is de facto a floating rate debt indexed on the central bank's key interest rate. And in terms of the cost of servicing the debt, it changes everything and creates an unprecedented rate sensitivity.

Stéphane Déo

Market review

Hoping for Fed pivot is dangerous wishful thinking

Short-lived respite for risky assets at the start of the fourth quarter

The BoE's emergency intervention has brought an uneasy calm to financial markets. Indeed, central bankers are stepping up their efforts to convince market participants that monetary tightening is far from over given lingering inflationary pressures. The US rate cuts priced in by the markets for 2023 look like wishful thinking. The knee-jerk reaction (upwards) in risky assets at the start of the quarter, visible in equities, credit indices and a decline in the dollar, gradually faded after the publication of the non-manufacturing ISM and then employment in the United States compatible with the continuation, for a few more months at least, of the economic cycle. Manufacturing surveys nevertheless predict a deceleration in activity. Inflation will remain key to the monetary policy outlook. Last week's increase in long-term rates is fully traceable to higher breakeven inflation rates. The new non-cooperative strategy of OPEC+ is a game-changer for the equilibrium of the oil market in 2023. Credit spreads eased slightly over the week despite renewed tensions on swap spreads. The shortage of collateral does not seem to be easing. On the other hand, sovereign debt spreads are remarkably stable in an environment of high volatility on the fixed income markets. The dollar resumed its upward trend at the end of the week.

UK Gilt's situation has gradually normalized thanks to the firm hand of the BoE, which has become a market maker of last resort, and to adjustments to the tax plan promised, under pressure, by the government of Liz Truss. The top tax bracket has been restored and the indexation of social benefits to inflation was scrapped, which may indeed reduce the unfunded amount of the stimulus plan. The BoE's emergency support is supposed to expire on October 14, a deadline now feared by market participants. The sense of market fragility also stems from the widespread belief in an imminent “pivot” from the Fed. The lower-than-expected rise in RBA rates (+25 bp) could certainly be interpreted as signaling an inflection point in the monetary cycle, but the Fed has clearly indicated that the rate cuts expected by the market in 2023 were unjustified. The monetary institution wants to ensure that financial conditions remain restrictive long enough to avoid a rebound in inflation when signs of recovery in the global economy will start to emerge. Activity is still quite depressed in China and Europe is slowing down after a resilient first half of the year. However, the fall in raw material prices seems to come to an end. The new OPEC's strategy, as the cartel reacts to the plan to cap oil and even gas prices in Europe, adds to upside risks on inflation. Crude price rebounded more than $10 over the past week as OPEC+ cut output quotas by as much as 2mbpd. Biden's strategy of rapprochement with Saudi Arabia thus appears to have failed. The use of US strategic reserves is also coming to an end and the US federal government will soon have to replenish strategic petroleum reserves, which will push oil prices higher over time. The fight against inflation is getting more complicated.

The financial markets would be wrong to believe in the reinstalment of a Fed put. The term structure of inflation expectations, which foreshadows a rapid deceleration in consumer price inflation, raises the risk of yield curve steepening if high inflation persists. A rise in long-term interest rates would rekindle the pressure on the valuations of risky assets, in particular growth stocks and long-term corporate credit. Worrying signals are coming from the bank loan market where some transactions fail to attract demand. The increasing cost of liabilities for CLOs weighs on the demand for leveraged loans. In this context, the rise in the US 10-year note yield to 3.90% sparked widening pressure in the 2s10s curve segment. Index-linked bonds remain the most attractive asset in this context. In the euro area, inflation at 10% leaves the ECB little room for maneuver. A 75 bp rate hike seems a certainty for the October 27 meeting. The ECB must also manage liquidity issues in money markets. A reverse tiering system is being studied to prevent banks from earning a margin on TLTRO funding. In turn, collateral scarcity still exerts widening pressure on swap spreads. The solution to collateral shortage is however obvious: the ECB could just lend a larger part of its portfolio at market rates. Such measures could be implemented quickly to avoid sharply negative repo rates around the end of the year. At the long end of the curve, Bund yields rose back towards 2.20% without affecting sovereign spreads. BTP spreads indeed trading around 240 bp and it is fair to say that long bond issuance in France and Spain have been well absorbed by the market. Unlike the June-July period, the ECB did not have to use maturities of risk-free bonds (Germany, Netherlands) to support peripheral debt in the past two months.

The credit market stabilized last week, but renewed tension on swap spreads seems to be penalizing both covered bonds and agency debt markets. Euro-denominated IG credit offers comfortable new issue premiums (20-25bp) to cushion against widening pressure in secondary markets. High yield remains very volatile but tightened last week. The iTraxx crossover has moved within a wide 100 bp trading range on poor investor sentiment and hedging needs.

Finally, as often, the dollar is the barometer of risk aversion, which is itself closely linked to monetary tightening in the United States.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	10-Oct-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	1.91%	+29	+58	+253
EUR Bunds 10y	2.34%	+43	+64	+252
EUR Bunds 2s10s	42.2bp	+13	+6	-1
USD Treasuries 2y	4.31%	+19	+75	+358
USD Treasuries 10y	3.88%	+24	+57	+237
USD Treasuries 2s10s	-43.3bp	+5	-18	-121
GBP Gilt 10y	4.47%	+51	+138	+350
JPY JGB 10y	0.25%	+1	+8	-5
€ Sovereign Spreads (10y)	10-Oct-22	1wk (bp)	1m (bp)	2022 (bp)
France	57.11bp	-2	-4	+20
Italy	229.07bp	-3	-11	+94
Spain	113.7bp	-2	-4	+39
Inflation Break-evens (10y)	10-Oct-22	1wk (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2.45%	+20	-4	+38
USD 10y Inflation Swap	2.51%	+14	-17	-26
GBP 10y Inflation Swap	3.69%	-62	-55	-49
EUR Credit Indices	10-Oct-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	222bp	-3	+15	+127
EUR Agencies OAS	95bp	+3	+8	+46
EUR Securitized - Covered OAS	116bp	+5	+7	+70
EUR Pan-European High Yield OAS	613bp	-18	+27	+295
EUR/USD CDS Indices 5y	10-Oct-22	1wk (bp)	1m (bp)	2022 (bp)
iTraxx IG	134bp	+1	+29	+86
iTraxx Crossover	645bp	+12	+132	+403
CDX IG	102bp	-3	+22	+52
CDX High Yield	582bp	-14	+119	+289
Emerging Markets	10-Oct-22	1wk (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	546bp	-13	+36	+178
Currencies	10-Oct-22	1wk (%)	1m (%)	2022 (%)
EUR/USD	$0.969	-1.354	-4.238	-14.7
GBP/USD	$1.103	-2.588	-5.589	-18.5
USD/JPY	JPY 146	-0.817	-1.990	-21.0
Commodity Futures	10-Oct-22	-1wk ($)	-1m ($)	2022 (%)
Crude Brent	$97.4	$8.5	$5.7	32.76
Gold	$1 667.4	-$32.5	-$57.2	-8.85
Equity Market Indices	10-Oct-22	-1wk (%)	-1m (%)	2022 (%)
S&P 500	3 612	-1.80	-11.19	-24.2
EuroStoxx 50	3 357	0.44	-5.97	-21.9
CAC 40	5 841	0.80	-5.98	-18.3
Nikkei 225	27 116	4.55	-3.89	-5.8
Shanghai Composite	2 974	-2.53	-8.83	-18.3
VIX - Implied Volatility Index	33.37	10.86	46.42	93.8

Source: Bloomberg, Ostrum AM

Additional notes

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