MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 081 // **September 5, 2022**

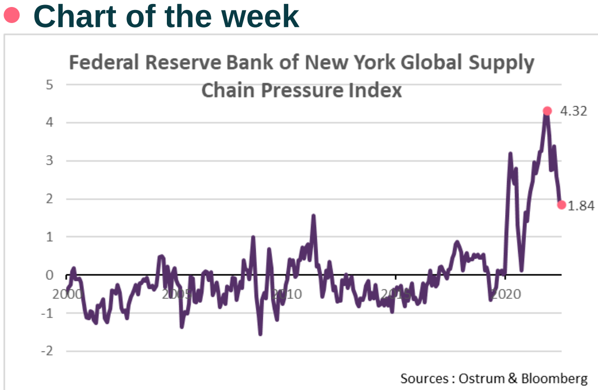
Topic of the week: Back to school! Summer round trip in bonds and equities

- **At first glance, little happened through the summer. Bond yields are close to June 30 levels and risky assets have recovered.**
- **Growth turned out to be stronger than expected thanks to the support of governments in Europe in the face of rising energy prices. Political risk in Italy and the UK, however, sparked bouts of volatility.**
- **That said, technical elements (repurchases of shorts) explain the easing of spreads (IG, HY) and the rebound in equities until mid-August.**
- **The rhetoric of central banks then turned more hawkish so that a trend reversal is taking shape.**
- **The dollar remains very strong, the euro oscillates around parity and the yuan adjusts to an unfavorable economic situation and to the monetary easing of the PBoC.**

Market review: No weekly review this week

- **The market review will resume on September 12th.**

Chart of the week



Supply problems remain very high when referring to the NY Fed indicator. However, the pressures are quickly fading. A sign that the situation is returning to normal, even if it is still far from normal.

It is mainly the Asian component that has eased with the partial reopening of China.

Figure of the week

65

Source : Ostrum AM

Germany is providing a €65 billion plan for purchasing power, or almost 2% of GDP.
This is huge, but we treat the symptoms (loss of purchasing power), not the fundamentals (energy dependence).

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Topic of the week

Back to school: summer round trip in bonds and equities

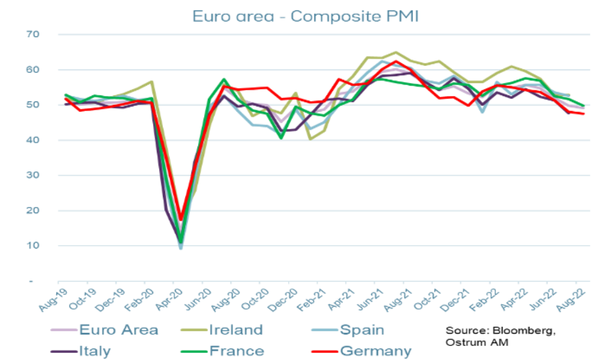
Whilst the levels of bond yields and credit spreads are not far off their June 30 close and equities enjoyed a summer rally, a lot has happened in the global economy and markets in the past two months. In this 'back to school' piece, we review some of the most important topics that drove markets over a volatile summer.

A resilient economy despite angst regarding energy prices

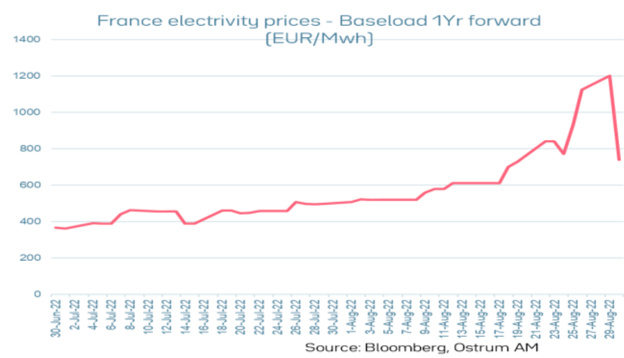
For all the talk of recession risks in the US and in Europe, one can be surprised by the relative strength in the hard data published since the beginning of July. Anxiety still prevails amid low PMI readings and dire consumer confidence.

The US economy contracted slightly in the three months to June (-0,6% according to the second estimate) but robust job creation and unemployment rate at all-time lows (3.5%) do not appear to fit the 'recession' script. Inflation is still elevated at 8.5% (July CPI) but declining gasoline prices finally provided welcome relief to the US consumer over the summer. Additional support will come from the Biden Administration's inflation reduction bill and other government initiatives aiming at student debt relief. At this juncture, although some prices have eased, wage pressures and high inflation expectations suggest that inflation may persist well into year-end.

In the euro area, economic growth surprised on the upside in the second quarter. France GDP increased 0.5% whilst Germany posted a modest 0.1% expansion, which turned out to be much better than expected given the low expectations regarding the German business cycle. Growth was even stronger in Italy and Spain, and it looks like the third quarter may even remain positive. Tourism in particular benefits a great deal from the weakening in the euro towards parity against the greenback. That said, some activity surveys point to slower growth in the coming months. PMI, for instance, have dipped below their 50 breakeven level in major economies in July. National surveys in France (INSEE) and Germany (IFO) paint a less negative picture.



Nevertheless, clouds are forming on the horizon. The energy crisis is indeed deepening. Russia has weaponized gas to hit countries supporting Ukraine. As a consequence, gas flows from Russia have fallen and stayed low even after maintenance works on a Nord Stream 1 turbine. Furthermore, US LNG exports to Europe have been constrained by an incident at an export terminal in Texas. European power prices have increased 10-fold from their pre-war norm to 1000 EUR/ MW/h in late August. Restrictions to Russian energy flows to Europe raise downside risks to activity next winter. Shortages of gas and electricity entail real risks for the months to come. A catastrophic recession this winter has a non-zero probability. For the reason, the EU announced it will intervene to regulate power markets.



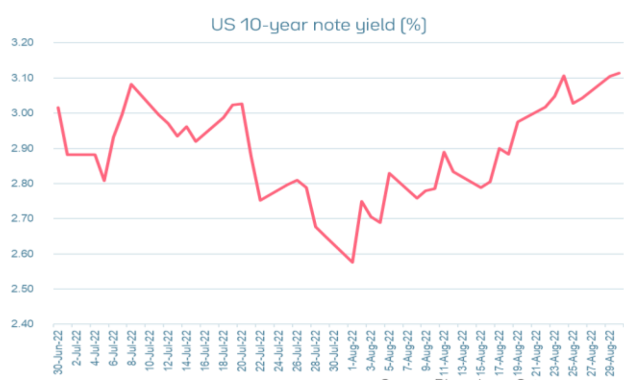
Make no mistake, euro area governments have acted forcefully to cushion activity and provide relief to households. Handouts (worth 20 billion euros in France for instance) cannot however last forever. In this context, euro area inflation will stay elevated and may even top 10% in the fall. The inflation backdrop is even worse in the UK where the next government will raise the cap on energy bills by 80% on October 1st. After the resignation of Boris Johnson, hard decisions will have to be made by the government to be formed in early September. Political crises are not unique to the UK. In Italy, the M5S pulled its support from the coalition government. Mario Draghi eventually resigned and general elections will be held on September 25th. Current polls indicate that a far-right coalition is likely, which in turn reignited a long-standing debate regarding the sustainability of Italian debt.

In Asia, China is still undergoing a sharp adjustment from the collapse in the real estate sector. Many Chinese real estate developers are in financial distress and unable to finish the construction of dwellings. The collapse in construction activity did weigh on industrial metals including copper and ferrous metals. A mortgage boycott is a source of concern for Xi Jinping which aims at a record-setting third term as President this autumn. Furthermore, the strict zero-covid policy is still an impediment to a revival of growth. Lockdowns in Shanghai and Beijing have caused a contraction in Chinese GDP of 2.6% in the second quarter. Domestic demand remains soft which partly explains the lower inflation readings in China. Consumer price inflation hovers around 2.7% in China.

Treasury markets: Fed signals tightening is not over

At first glance, markets look to have traded sideways since July. About 3.10%, current US 10-year Treasury yields trade only a few basis points above their June close and major equity gauges are up. Nevertheless, market action was far from smooth through the summer. Investor sentiment swinging from recession to inflation and false signals from the Fed caused bouts of volatility.

In bond space, US yields hit a low at 2.57% (close) in the wake of the July 27 FOMC. Jerome Powell had suggested in the Q&A session that the Fed funds rate may be close to neutral after hiking rates to 2.5%. The ensuing 50bp rally in 10-year yields in the days following the July FOMC caused unattended easing in monetary conditions amid high inflation. Investors clearly anticipated that the Fed would blink and pivot to a dovish stance. Jerome Powell made a short 8-minute speech at Jackson Hole to reaffirm the Fed's commitment to price stability. The message from Powell is that there is no possible trade-off between inflation and unemployment/growth at present. A recession may be needed to bring down inflation. In essence, the Biden government's plan to reduce inflation gives additional leeway to the Fed to pursue a tighter policy stance. In the wake of the Jackson Hole address, yields crept higher towards 3.10%.



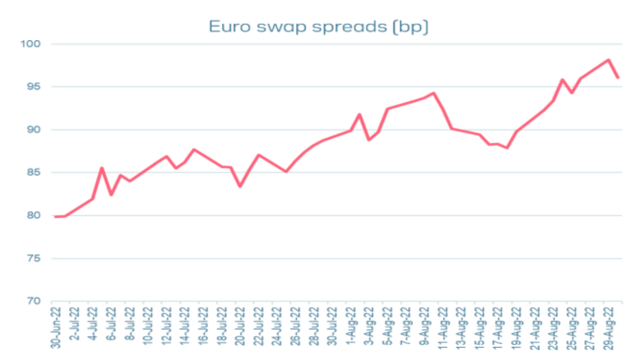
In addition, the US yield curve (2s10s spread near -30 bp) remains inverted. The inversion mostly relates to the expected path for Fed funds rates but the Fed's balance sheet reduction policy is also to blame. Quantitative tightening since June has fallen short of the target for $47.5 billion cutback in asset holdings. Quantitative tightening may double from September as the Fed lets its bill holdings mature. Faster pace of quantitative tightening may contribute to restore term premia in the months ahead.

ECB navigating inflation, political and financial stability risks

In the euro area, the ECB raised interest rates by 50 bp in July for the first time in a decade. Whilst 9% inflation is the main source of concern for the ECB, policymakers are also wary of potential risks to financial stability. For these reasons, Christine Lagarde announced the launch of a new policy tool, the Transmission Protection Instrument (TPI), aimed at mitigating the risks of unwarranted widening in sovereign spreads. The first line of defense against spread volatility remains the flexibility offered by the reinvestments of PEPP proceeds. The ECB has already made use of such leeway by cutting Bund and DSL holdings to support peripheral bond markets since the start of summer. The ECB reinvestments helped to stabilize Italian sovereign spreads although upward pressure resume in late August as investors look to the upcoming general elections. Hedge funds amassed a large short position. BTP spreads, near 230 bp at present, have thus ranged between 190 and 240 bp against Bunds since the end of June. To be fair, the TPI scheme did reduce contagion risks across markets, but it also enables the ECB to act more forcefully on inflation. Indeed, several ECB policymakers made clear that higher rates are to be expected from September onwards.

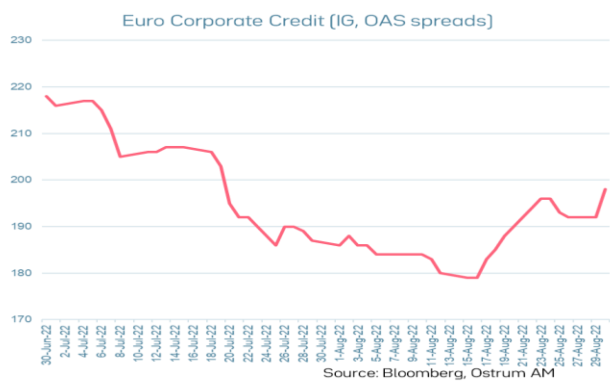
Credit short squeeze in July gives way to widening pressure in August

After a rough first half of year, swap spreads resumed ascending in August from already high levels. Hedging (paying) flows from banks and the scarcity of high-quality collateral pushed swap spreads above 100 bp.



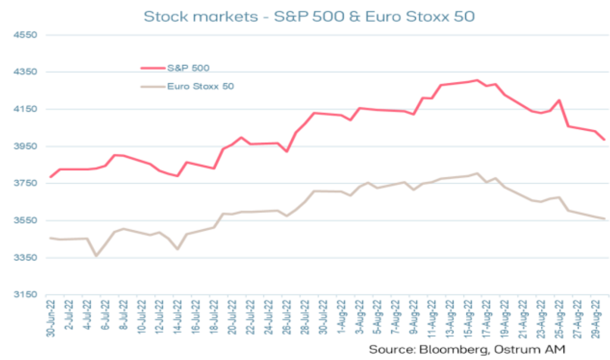
Such levels are usually associated with banking crises or liquidity crunches. Flight to quality flows as Italian spreads increased may have driven spreads wider.

Early on this spring, upward pressure on swap spreads had foreshadowed a sharp widening in corporate credit spreads. Although credit spreads have tightened by 26 bp against Bunds since the June close, corporate debt markets proved volatile throughout the summer period. In early June, a short squeeze led to tighter spreads as investors removed protection built in the spring credit rout. Liquidity had been very poor since the outbreak of the war so that final credit investors opted for short risk CDS exposure. The unwinding of credit hedging amplified a rally in the battered Swedish real estate sector -from senior to cheap hybrid bonds) and the broader corporate bond market. Credit fund inflows also improved somewhat after months of heavy selling in the second quarter. Primary market activity was limited as expected in July-August (5 billion euros issued). July was the first month without net buying of corporate bonds from the ECB. The Central bank still reinvests CSPP proceeds.



High yield also benefitted from the cutback in credit hedges. Euro high yield spreads are down more than 100 bp from the end of June. Heavy protection buying via the iTraxx crossover index in May-June gave way to a sharp pullback in speculative-grade spreads. Default rates are still low, and the primary markets remain essentially shut throughout the summer. The fund flow balance improved at the margin as risk aversion and risk premia receded.

Stock markets rose from mid-July reaching a peak on August 17th. The short covering spurt evident in credit markets also helped equities higher. US leveraged investors had built a short base comparable to that of the spring 2020. As the Fed hinted at neutrality in late July, the S&P 500 crept higher to reach an August peak above 4300. The US market then retraced gains as the Fed rhetoric turned more hawkish. The US quarterly earnings season was strong with 75% of firms beating consensus estimates by 4% on average. Earnings and pricing power indeed proved more resilient than anticipated as sales also surprised on the upside in all sectors but technology. Energy continues to lead gains. Utilities also had a good run in August.



In Europe, the Euro Stoxx 50 closely followed the US trend. Earnings surprises were arguably more mixed than in the US but year-on-year growth were in double-digit territory (+15% for the broad Europe Stoxx index). Sales growth were unheard of in the energy and utilities sectors but also upbeat in consumer and industrials space. The weak euro is a boon for many dollar earners.

Indeed, in foreign exchange markets, king dollar reigns. The sharp deceleration in China growth forced the PBoC to cut interest rates and allow an orderly depreciation in the yuan. The euro is undergoing a sharp terms of trade shock as energy prices turned a long-standing trade surplus into a deficit. Hence, the euro fell to parity against the US dollar. Likewise, Sterling weakened through post-Brexit lows. The Japanese yen keeps trading lower as the BoJ sees no reason to change course on monetary policy.

Conclusion

Bonds and equities made a round trip this summer as US 10-year yields reverted to 3%. Central bank turned more hawkish again as inflation risks persist causing a pullback in risk assets from mid-August highs. Credit tightened due to short covering in July but wider spread spreads ignited renewed weakness in corporate bonds in August. Political risks loom large in the UK and in Italy.

Axel Botte

Market review

No weekly review this week

The market review will resume on September 12th.

Axel Botte

Global strategist

Main market indicators

G4 Government Bonds	05-Sep-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	1.13%	+3	+65	+175
EUR Bunds 10y	1.56%	+6	+61	+174
EUR Bunds 2s10s	42.9bp	+3	-4	-1
USD Treasuries 2y	3.39%	-4	+16	+266
USD Treasuries 10y	3.19%	+9	+36	+168
USD Treasuries 2s10s	-20.6bp	+12	+20	-98
GBP Gilt 10y	2.94%	+34	+89	+197
JPY JGB 10y	0.24%	-1	-12	-15
€ Sovereign Spreads (10y)	**05-Sep-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	62.67bp	+1	+1	+25
Italy	237.53bp	+8	+3	+102
Spain	120.5bp	+2	+1	+46
Inflation Break-evens (10y)	**05-Sep-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.51%	-23	-2	+44
USD 10y Inflation Swap	2.72%	-12	-4	-5
GBP 10y Inflation Swap	4.48%	-22	+30	+31
EUR Credit Indices	**05-Sep-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	209bp	+17	+25	+114
EUR Agencies OAS	92bp	+7	+12	+43
EUR Securitized - Covered OAS	113bp	+9	+15	+67
EUR Pan-European High Yield OAS	595bp	+51	+43	+277
EUR/USD CDS Indices 5y	**05-Sep-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	119bp	+6	+17	+71
iTraxx Crossover	582bp	+25	+65	+340
CDX IG	92bp	+5	+11	+43
CDX High Yield	529bp	+22	+62	+237
Emerging Markets	**05-Sep-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	511bp	+21	-9	+142
Currencies	**05-Sep-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$0.993	-0.670	-2.485	-12.7
GBP/USD	$1.152	-1.640	-4.605	-14.9
USD/JPY	JPY 141	-1.309	-3.949	-18.1
Commodity Futures	**05-Sep-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$95.7	-$7.2	$2.6	29.68
Gold	$1 708.9	-$28.2	-$66.6	-6.57
Equity Market Indices	**05-Sep-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 924	-3.29	-5.33	-17.7
EuroStoxx 50	3 490	-2.25	-6.32	-18.8
CAC 40	6 093	-2.07	-5.86	-14.8
Nikkei 225	27 620	-0.93	-1.97	-4.1
Shanghai Composite	3 200	-1.26	-0.84	-12.1
VIX - Implied Volatility Index	25.99	-0.84	22.88	50.9

Source: Bloomberg, Ostrum AM

Additional notes

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