# MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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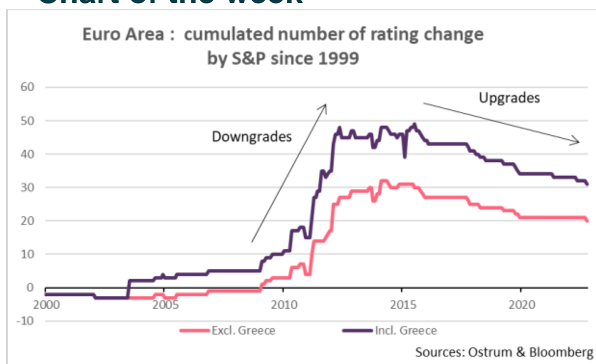
## Topic of the week: Jerome Powell vs. Diego Maradona

- **The Jackson Hole's speech was unambiguously "hawkish". Paradoxically, the main message is perhaps more about long rates and the slope of the curve than about the immediate trajectory of Fed funds.**
- **The rate cuts anticipated by the market for next year are probably much less likely than the market thinks.**
- **This would also imply a steeper curve. Longer rates higher for longer.**

## Market review: The ECB acts forcefully

- **ECB: unprecedented 75bp hike, firmness against inflation**
- **Sharp rebound in risk assets (bank stocks, HY) after the ECB decision**
- **Tightening in swap spreads as ECB reserve tiering ends**
- **Yen briefly tumbles past 144**

## Chart of the week




Portugal has been upgraded to BBB+ by S&P. Althouh the timing is slightly surprising while Europe is in the midst of an energy crisis. However the performance of the economy and the ambitious fiscal consolidation implement fully justify the move.

More generally, Europe faced a large wave of downgrades during the sovereign crisis. If there's been numerous upgrades during the second half of last decade, the pace has considerably slowed lately.

## Figure of the week

**22%**

In 2021, oil and gas production accounted for 22% of methane emissions, according to IEA

Source : Ostrum AM

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Topic of the week

# Jerome Powell vs. Diego Maradona

**The Jackson Hole's speech was unambiguously "hawkish". Paradoxically, the main message is perhaps more about long rates and the slope of the curve than about the immediate trajectory of Fed funds.**

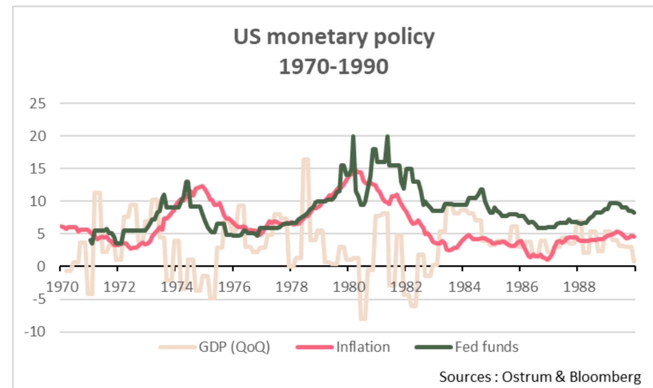
## Powell vs. Volker

J. Powell's speech at Jackson Hole was a cold shower for the markets. No "pivot" of the Fed but on the contrary an unambiguous message about the Fed's willingness to fight inflation.

The message, beyond the 3 mentions of Paul Volcker, the absolute icon of the anti-inflation fight, is essentially summarized in three points:

1. Central Banks must maintain a restrictive policy for a long time to avoid a rebound in inflation.
2. Inflation expectations are key to realized inflation.
3. The cost of inaction in terms of jobs is increasing over time.

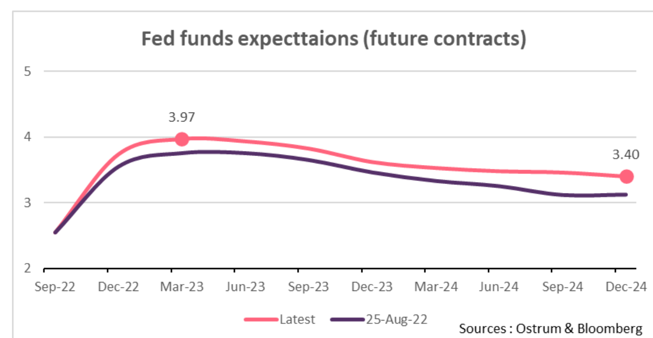
The references to the years 1970-1980, beyond the repeated hat-offs at Volcker, were numerous despite the brevity of the intervention. One of the pitfalls that Powell seems to want to avoid is the 1970s sequence that we show in the chart below. Inflation rebounded sharply, 12.3% in December 1974, and the Fed reacted to 13% in mid-1974. The result was a hard recession in 1974-75 which brought inflation down to 5% just over a year later. The mistake was to declare victory and the Fed quickly lowered its key rates to 5%. The subsequent recovery was accompanied by a rebound in inflation. Once inflation was anchored, it took Volker's horse remedies, a decade of very positive real rates, to finally bring inflation down.



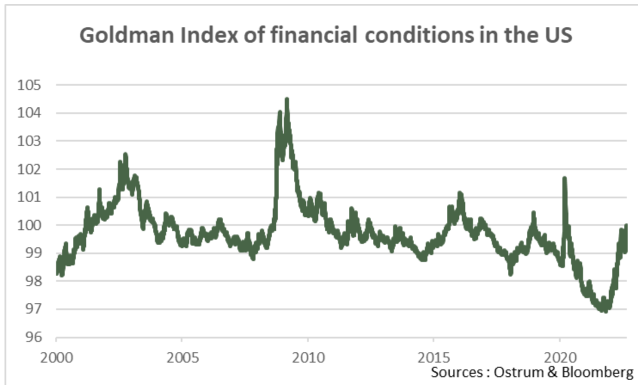

To pick up on Powell's three points: (1) the Fed was too quick to relax its policy (2) and therefore expectations were unanchored (3) which eventually led to a high total cost to the economy with a restrictive monetary policy for more than a decade.

## Powell vs. the market

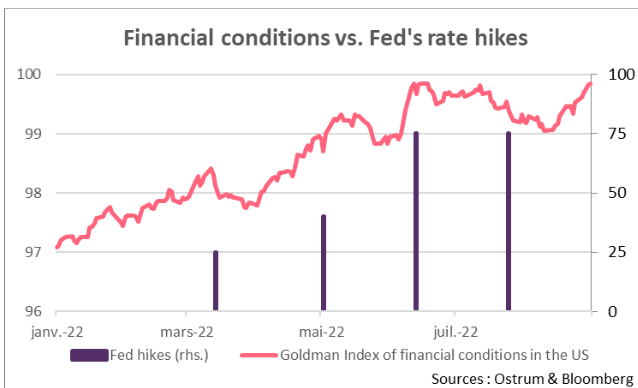
The market doesn't believe in it or at least didn't believe in it. The chart below shows market expectations on Fed funds before Jackson Hole. The story, in short, is that of a very aggressive Fed this year but that turns around by the middle of next year. Not a prolonged tightening of monetary policy, but rather a stop-and-go that is reminiscent of the 1970s. The graph also shows current expectations: if the idea of rates remaining high is (a little) taken into account, we are far from the guidance of the Fed.



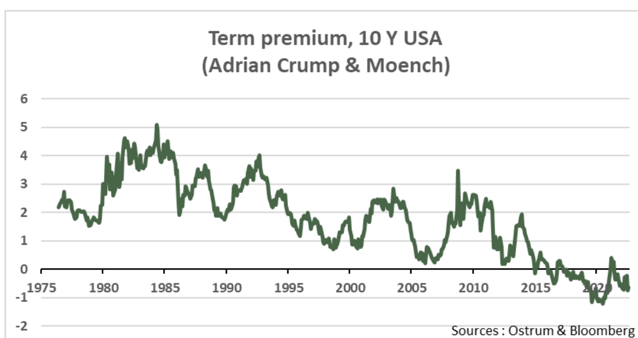

The consequence is that, paradoxically, financial conditions are still not restrictive in the United States despite a very clear rebound.




The previous rate hikes were followed, paradoxically, by a relaxation of financial conditions in the sessions that followed. Part of this relates to the fact that Powell's post-FOMC's speeches tended to reassure markets about the degree of tightening. It is also the fact that long-term rates finally moved little, the Treasury was at 3.03% on the morning of Jackson Hole, the same level as mid-April.




One of the problems for the Fed, and therefore one of its challenges is to give back the term premium. The graph below shows that for the moment we are far from it.




In this sense, Jackson Hole's speech is more important in terms of the equilibrium level of long rates than in terms of the trajectory of short rates at the end of this year.

# Powell vs. Maradona

It is interesting to go back to Sir Mervyn King, the former governor of the BoE. Sir Mervyn is known for his sense of humor. We owe him the quote, "There are three types of economists, those who know how to count and those who don't", or "a successful central banker is a boring one".

He also coined the Maradona theory of monetary policy. The idea is to go back to Maradona's goal against England in the World Cup: he crosses the entire field zigzagging in the English defense.

"What's really remarkable is that Maradona ran almost in a straight line. How do you beat five players by running in a straight line? The answer is that the English defenders reacted to what they expected from Maradona; whether Maradona moved left or right" said Sir Mervyn in 2005.

The analogy with monetary policy is that if markets expect rate hikes when inflation rises, their inflation expectations do not move and therefore the central bank does not need to raise rates. The trajectory of monetary policy is as linear as Maradona's.

In other words, the more credible the central bank is, the less need it has to react to changes in inflation.

That's kind of the Fed's dilemma right now. With markets that do not believe they will keep high rates next year, the Fed may be forced to do even more (an anti-Maradona) to offset the credibility deficit. Hence the importance of current discourse. If they are effective, long rates should be higher than they are now, which, paradoxically, would be part of the Fed's job and therefore limit its need to hike Fed funds.

# Conclusion

The error of premature monetary policy easing in the 1970s seems to be very much on the Fed's mind. This seems reasonable to us, but it would also imply that the rate cuts anticipated by the market for next year are probably much less likely than anticipated. This would also imply a steeper curve. Longer rates higher for longer.

### Stéphane Déo

## Market review

# The ECB acts forcefully

### First 75bp rise and firmness against inflation, real rates rise without harm to risky assets

For once, Christine Lagarde seems to have succeeded in her communication. Equity markets welcomed the unprecedented 75bp rate hike and the resolutely aggressive rhetoric in the face of rising inflation. The Schatz yield climbed towards 1.4%. Technical measures also ensure better transmission of the ECB's monetary policy to the short-term money markets. The welcome tightening of swap spreads in the euro area led to a widespread narrowing of credit spreads. The sharp rise in real rates reflects the ongoing monetary tightening bias in the euro area and, of course, in the United States, as Jerome Powell reiterated his objective of conducting a more restrictive monetary policy going forward. The yield on T-note is now trading around 3.3%. The dollar nonetheless retreated as risk asset markets enjoyed a sharp rebound. We are also struck by the extreme weakness in the Japanese yen, even as it eased somewhat to 142 against the greenback at the end of the week.

The ECB's decision was eagerly awaited. The Frankfurt institution embraced the 75 bp-hike fashion, and it looks like further hikes are already planned by the ECB. Inflation was still accelerating at 9.1% in August and the near-term price outlook looks unfavorable due in part to the weakness of the euro. Admittedly, the easing in oil prices ($85) is beneficial, but domestic inflationary are now undeniable. The ECB now projects a 5.5% rise in consumer prices next year, 2pp more than the June forecast. Inflation would remain above 2% by 2024 according to the monetary institute. On the other hand, growth will come to a halt during the winter (Q4-Q1) after the strong growth numbers through the summer thanks to fiscal support. Among the many national government initiatives, Germany announced a €65 billion package to limit the impact of higher energy prices. One can regret the lack of a coordinated response among euro area member states, especially since the European Commission is about to unveil a contingency plan to deal with the risk of energy shortage. Fiscal support however complicates the return to price stability for the European central bank. As for the money markets, the tensions on the repo market place may diminish thanks to the end of the bank reserve tiering system, rendered obsolete by the positive interest rates, and the temporary increase in the interest rate applicable to government deposits (set at the minimum between the deposit rate and ESTR).

The bond markets experienced another week of high volatility. The German yield curve flattened as the market priced in a new ECB rate path. Bund yields soared above 1.70% but it was the short-term yields that adjusted the most. The measures limiting the excess of loanable funds on the repo had the beneficial effect of narrowing swap spreads. Collateral scarcity at the source of these tensions should ease. The 2-year swap spread narrowed from 122 bps at last Monday's high to 95 bps at the end of the week. The easing in swap spreads is accompanied by the tightening in sovereign spreads. The Italian political risk is strangely ignored by markets at this juncture, but it is advisable to maintain a short bias on Italian BTPs in the run-up to the September 25 elections and beyond as budgetary orientations and the continuation of reforms undertaken by the previous government could be in jeopardy. In the United States, the Fed is continuing its strategy of rapidly raising interest rates before an extended status quo in 2023 (around 4%?). However, the US yield curve remains inverted (2-10 years) and the challenge now is to restore a positive term premium by doubling the pace of quantitative tightening. The Fed's stock of T-bills will be used to achieve the €60 billion monthly target on maturities of the Treasuries portfolio. The hawkish policy backdrop is weighing on inflation breakeven, especially as oil prices are falling. WTI is below $85. The reduction in OPEC output (-100k bpd) is meaningless in the short term. A cap on Russian oil prices, wanted by Washington, will be put in place from December 5. This mechanism may make it possible to compensate for the end of the use of US strategic petroleum reserves.

The credit market benefited from the rebound in risky assets but remains fragile. The IG market in the euro zone is trading at 203 bp against Bund or 112 bp against swap. The early return of issuance (financial in particular), from mid-August, reversed the tightening trend on IG spreads in the euro area. The primary market should remain lively, but the balance of flows to the asset class remains unfavorable. Thus, the generous new issue premiums (20 bp on average) do not guarantee subsequent positive excess returns in secondary markets. On high yield, spreads fell by 20bp this week to 563bp against Bunds with a good performance from hybrids and bank AT1s. However, the new issuance drought continues.

The rebound in equities comes mainly from the US. The Nasdaq gained 2% resisting the rise in long rates. The upbeat US earnings season, despite a strong dollar, helped stock prices in the face of monetary tightening. Europe (+1%) is also up thanks to the banking sector which benefits from the rise in rates. Bank stocks were up nearly 5% last week. The oil sector underperformed (-2.6%).

Finally, the dollar is still a barometer of risk aversion. The rebound in risk assets hit the greenback. However, carry prevents a sharp dollar retracement. Conversely, the yen slide to nearly 145 caught our attention, as the BoJ fails to intervene. But until when ?

**Axel Botte**
Global strategist

## Main market indicators

| G4 Government Bonds | 12-Sep-22 | 1wk (bp) | 1m (bp) | 2022 (bp) |
|---|---|---|---|---|
| EUR Bunds 2y | 1.32% | +19 | +71 | +194 |
| EUR Bunds 10y | 1.68% | +12 | +69 | +186 |
| EUR Bunds 2s10s | 35.2bp | -8 | -2 | -8 |
| USD Treasuries 2y | 3.54% | +15 | +29 | +280 |
| USD Treasuries 10y | 3.29% | +11 | +46 | +178 |
| USD Treasuries 2s10s | -24.8bp | -4 | +17 | -102 |
| GBP Gilt 10y | 3.08% | +14 | +97 | +211 |
| JPY JGB 10y | 0.25% | +1 | -11 | -14 |
| **€ Sovereign Spreads (10y)** | **12-Sep-22** | **1wk (bp)** | **1m (bp)** | **2022 (bp)** |
| France | 57.11bp | -6 | -4 | +20 |
| Italy | 230.16bp | -7 | -5 | +95 |
| Spain | 114.74bp | -6 | -5 | +40 |
| **Inflation Break-evens (10y)** | **12-Sep-22** | **1wk (bp)** | **1m (bp)** | **2022 (bp)** |
| EUR 10y Inflation Swap | 2.48% | -3 | -13 | +41 |
| USD 10y Inflation Swap | 2.66% | -6 | -7 | -11 |
| GBP 10y Inflation Swap | 4.34% | -14 | +19 | +16 |
| **EUR Credit Indices** | **12-Sep-22** | **1wk (bp)** | **1m (bp)** | **2022 (bp)** |
| EUR Corporate Credit OAS | 197bp | -8 | +13 | +102 |
| EUR Agencies OAS | 84bp | -5 | +3 | +35 |
| EUR Securitized - Covered OAS | 101bp | -8 | +1 | +55 |
| EUR Pan-European High Yield OAS | 554bp | -31 | +6 | +236 |
| **EUR/USD CDS Indices 5y** | **12-Sep-22** | **1wk (bp)** | **1m (bp)** | **2022 (bp)** |
| iTraxx IG | 103bp | -15 | +11 | +56 |
| iTraxx Crossover | 505bp | -74 | +37 | +263 |
| CDX IG | 81bp | -11 | +6 | +32 |
| CDX High Yield | 471bp | -58 | +47 | +178 |
| **Emerging Markets** | **12-Sep-22** | **1wk (bp)** | **1m (bp)** | **2022 (bp)** |
| JPM EMBI Global Div. Spread | 491bp | -20 | -8 | +122 |
| **Currencies** | **12-Sep-22** | **1wk (%)** | **1m (%)** | **2022 (%)** |
| EUR/USD | $1.014 | 2.135 | -1.150 | -10.8 |
| GBP/USD | $1.167 | 1.355 | -3.831 | -13.7 |
| USD/JPY | JPY 143 | -1.479 | -6.510 | -19.4 |
| **Commodity Futures** | **12-Sep-22** | **-1wk ($)** | **-1m ($)** | **2022 (%)** |
| Crude Brent | $93.9 | -$1.9 | -$3.0 | 27.13 |
| Gold | $1 726.8 | $16.4 | -$75.6 | -5.60 |
| **Equity Market Indices** | **12-Sep-22** | **-1wk (%)** | **-1m (%)** | **2022 (%)** |
| S&P 500 | 4 067 | 2.53 | -4.97 | -14.7 |
| EuroStoxx 50 | 3 619 | 3.68 | -4.19 | -15.8 |
| CAC 40 | 6 289 | 3.21 | -4.04 | -12.1 |
| Nikkei 225 | 28 542 | 3.34 | -0.02 | -0.9 |
| Shanghai Composite | 3 262 | 2.37 | -0.45 | -10.4 |
| VIX - Implied Volatility Index | 23.41 | -8.09 | 19.87 | 35.9 |

Source: Bloomberg, Ostrum AM

## Additional notes

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