# MyStratWeekly
Market views and strategy

Ostrum
ASSET MANAGEMENT

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N° 139 // **December 18, 2023**

## Topic of the week: Divergence between the Fed and the ECB

- **The Fed made a significant change in communication by indicating that the possibility of rate cuts had been discussed;**
- **This appears premature given the resilience of growth, a robust job market and inflation still high;**
- **The ECB, for its part, remained cautious due to the sharp increase in unit labor costs. It's waiting for data from the first half of 2024 to judge the evolution of salaries;**
- **A major divergence thus took place between the Fed and the ECB. Despite the ECB's efforts to contain market expectations, they have retained the significant change in communication from the Fed and anticipate rate cuts that are still too aggressive.**

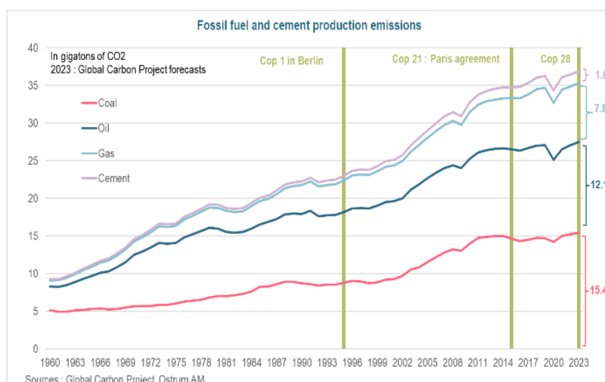
**Axel Botte**
Head of Market Strategy
axel.botte@ostrum.com


## Market review: The Fed uncorks the Champagne

- **Powell delivers easing signal;**
- **Everything rally get yet another boost from Fed;**
- **ECB and BoE sound more cautious about inflation risks;**
- **PEPP to shrink by 7.5 billion a month from July.**

**Zouhoure Bousbih**
Emerging countries strategist
Zouhoure.bousbih@ostrum.com


## Chart of the week




The final communiqué of Cop 28 is mixed. For the first time, it calls on countries to undertake a "transition away from fossil fuels" in a fair, orderly and equitable manner, while accelerating action this decade to achieve carbon neutrality by 2050. On the other hand, the text does not set a deadline for phasing out fossil fuels, nor does it set specific objectives. The statement also calls for tripling global renewable energy capacity and doubling energy efficiency by 2030.

This text is a compromise allowing each country to adopt its own pace to move away from fossil fuels and the means to achieve this without creating a collective dynamic.

**Aline Goupil- Raguénès**
Developed countries strategist
aline.goupil-raguenes@ostrum.com


## Figure of the week

**54**

Source : Bloomberg

Two days after his inauguration, the Argentine government of Javier Milei announced a 54% devaluation of the official exchange rate of the peso against the dollar (to 800 pesos to the dollar) and a reduction in public aid to try to stabilize the economy.

● Topic of the week

# Divergence between the Fed and the ECB

**Central banks took center stage last week. These meetings were eagerly awaited due to the aggressive rate cuts anticipated by the markets. A divergence has occurred between the Fed and the ECB in terms of communication. Jerome Powell completely changed his tune in less than 15 days, indicating that discussions had focused on when it would be appropriate to lower rates, contrasting with the ECB for which the subject was not broached. The markets have retained the Fed's upcoming pivot and continue to anticipate excessive reductions in key rates.**

## Fed pivot

The Fed kicked off the central bank meetings on December 13. As expected, it decided to leave its rates unchanged for the third consecutive time, after having raised them by 525 basis points between March 2022 and July 2023. The Fed funds rate was thus maintained in the range [5.25% ; 5.50%]. It also continues to gradually reduce the size of its balance sheet, which makes its monetary policy more restrictive. It reduces Treasury reinvestments by $60 billion per month and those of mortgage-backed securities (MBS) by $35 billion per month.

### Downward revision of inflation outlook

The Fed has revised its inflation outlook significantly downward in 2023 and to a lesser extent in 2024 and 2025 to 2.8%, 2.4% and 2.1% respectively. They remain unchanged at 2% in 2026 and in the long term. It included the faster-than-expected slowdown in inflation to 3.1% in November.

Core inflation expectations have also been revised sharply lower in 2023 (3.2% compared to 3.7%) and to a lesser extent in 2024 and 2025 (2.4% and 2.2% respectively).

Concerning growth prospects, the strong figures for Q3 led it to significantly revise the forecasts for 2023 (2.6% against 2.1%). Growth, on the other hand, was revised slightly downward in 2024, to 1.4%, with growth showing signs of moderation. The slowdown is occurring without generating a significant increase in the unemployment rate. It remains expected at 4.1% in 2024 and 2025, compared to 3.8% in 2023.

An important point was the downward revision of Fed funds rate expectations. In September, the median forecast of FOMC members was for a final rate hike in 2023 followed by 2 rate cuts in 2024. In December, FOMC members no longer expected a rate hike and on average anticipated 3 rate cuts in 2024 and 4 reductions in 2025. However, they reserve the possibility of raising them if necessary.

FOMC Member Median Forecasts for September and December 2023

Year-on-year (Q4/Q4) for growth and inflation

| | 2023 | | 2024 | | 2025 | | 2026 | | Longer term | |
|---|---|---|---|---|---|---|---|---|---|---|
| | December | September | December | September | December | September | December | September | December | September |
| Growth | 2.6 | 2.1 | 1.4 | 1.5 | 1.8 | 1.8 | 1.9 | 1.8 | 1.8 | 1.8 |
| Unemployment rate | 3.8 | 3.8 | 4.1 | 4.1 | 4.1 | 4.1 | 4.1 | 4 | 4.1 | 4 |
| PCE inflation | 2.8 | 3.3 | 2.4 | 2.5 | 2.1 | 2.2 | 2 | 2 | 2 | 2 |
| Core PCE inflation | 3.2 | 3.7 | 2.4 | 2.6 | 2.2 | 2.3 | 2 | 2 | | |
| Fed funds rate | 5.4 | 5.6 | 4.6 | 5.1 | 3.6 | 3.9 | 2.9 | 2.9 | 2.5 | 2.5 |

PCE: Household consumption expenditure deflator
Sources: Fed, Ostrum AM

### Discussions on the timing of rate cuts

During the Q&A session of the press conference, Jerome Powell said there had been discussions about when it would be appropriate to cut rates. This is a radical change in communication compared to the comments made on December 1st. The Chairman of the Fed had indicated that it was too early to talk about rate cuts. In the meantime, inflation came out lower than expected, but underlying inflation stabilized at a high level (4% in November) and inflation in services excluding real estate increased. It has accelerated to reach 3.9%, compared to 3.7% in October. Jerome Powell even cited a forecast for the household consumption expenditure deflator for the month of November (PCE index, the Fed's preferred inflation measure). It is expected at 3.1%, compared to 3.5% in October.

Another disturbing element lies in the press release published following the Fed meeting. It is further indicated that tense financial conditions should weigh on activity, the job market and inflation. No mention was made of the significant easing of financial

conditions which has taken place since mid-November following the sharp fall in bond rates and the rise in equity markets. This is likely to counter the tightening carried out by the Fed. Jerome Powell did nothing to calm expectations of a rate cut as he should have. On the contrary, he validated them. The risk is that in a context of housing shortage, the relaxation of financial conditions amplifies the rise in real estate prices which is taking place and thus contributes further to inflation.

## The ECB does not let its guard down

The ECB opted for the status quo for the second time in a row by leaving the deposit rate at the historic high of 4%. This follows 10 consecutive increases, totaling 450 basis points, carried out between July 2022 and September 2023.

The sentence in the press release according to which "inflation should always remain too high for too long" has disappeared to make way for "inflation has slowed significantly in recent months but it should rise temporarily in the short term". The ECB takes note of the sharp slowdown in inflation which fell from a historic peak of 10.6%, in October 2022, to 2.4%, in November 2023, mainly due to the strong negative contribution of energy prices. The press release accompanying the decision indicates the maintenance of tensions on domestic prices linked mainly to the sharp increase in unit labor costs. The latter in fact accelerated in the 3rd quarter, to 6.6% year-on-year, due to the strong increase in wages (5.2%) and the drop in productivity (-1.2%).

### Downgraded outlook revisions

The ECB has revised its inflation outlook downwards compared to the September meeting for the year 2023 (5.4% against 5.6%) and especially the year 2024 (2.7% against 3.2%), as shown in the table below. This results from the faster-than-expected disinflation that has occurred and lower energy price assumptions based on market expectations. Inflation in 2025 is approaching the target of 2% (2.1% on average) and should reach it in the second half of that year.

ECB forecasts for September and December 2023 (annual average)

| | 2023 | | 2024 | | 2025 | | 2026 |
|---|---|---|---|---|---|---|---|
| | december | september | december | september | december | september | december |
| Growth | 0.6 | 0.7 | 0.8 | 1 | 1.5 | 1.5 | 1.5 |
| Inflation | 5.4 | 5.6 | 2.7 | 3.2 | 2.1 | 2.1 | 1.9 |
| Core inflation | 5 | 5.1 | 2.7 | 2.9 | 2.3 | 2.2 | 2.1 |

Sources : ECB, Ostrum AM

Core inflation was also revised downward in 2023 and 2024 but to a lesser extent due to the persistence of domestic tensions linked in particular to wages. Core inflation is expected at 5% in 2023 and 2.7% in 2024 then 2.3% in 2025 and 2.1% in 2026.

Growth was revised downward to 0.6% in 2023 and 0.8% in 2024, compared to 0.7% and 1% previously. This results from the impact of monetary tightening and weak global trade. A gradual recovery is expected next year with rising real incomes and a strengthening in global trade.

### A rate cut was not discussed at all

Despite the downward revision of the growth and inflation outlook, the ECB has not modified its communication aimed at keeping rates in restrictive territory long enough to allow inflation to return to around 2% in the medium term.

During the question and answer session, Christine Lagarde was very clear: a rate cut was not discussed at all. This contrasted with Jerome Powell's statements the day before. The President of the ECB insisted on the fact that it must not let its guard down, as the work to curb inflation is not done.

### Announcement of a reduction in reinvestments of PEPP payments and their cessation

The PEPP (emergency purchasing program to deal with the pandemic) was not only discussed, as C. Lagarde's recent statements suggested, but a decision was taken at this meeting, which was not expected so soon.

Until now, reinvestments of repayments of bonds acquired under the PEPP were to continue at least until the end of 2024. This is no longer the case. Full

reinvestment of proceeds will continue in the first half of 2024 then it will be reduced by half in the second half of the year, to the tune of 7.5 billion euros per month. The reinvestments will end at the end of 2024.

The flexibility of the PEPP, in the event of unjustified tensions on the rates of certain countries, can thus still be fully used in the first half of the year, when the financing needs of States will be greater. It will be to a lesser extent in the second half of the year. The stability of Italy's spread around 175 basis points since mid-November has probably reassured the ECB to lead it to announce this decision in December.

The balance sheet also continues to shrink through the cessation of reinvestments under the APP (asset purchase program) and repayments of TLTROs (targeted long-term refinancing operations). This normalization of asset purchase programs contributes to making monetary policy more restrictive despite the status quo on rates.

### Importance of upcoming data on wages and unit profits

The ECB remains cautious due to the pressures which continue to be exerted on domestic prices with the sharp rise in unit labor costs. Future rate developments will depend on the inflation outlook, underlying inflation and the impact of monetary tightening. Christine Lagarde insisted on the importance of publishing data in the first half of 2024 concerning salaries, the job market and the evolution of unit profits.

The aim will be to see whether wages begin to moderate and whether companies will absorb the increase in wage costs more significantly through a reduction in their margins. Unit profits had contributed more to the acceleration of inflation in 2022 than wage costs. Given the sharp rise in unit labor costs and the waiting for data in the first half, and more particularly the results of wage negotiations, a rapid rate cut from the ECB is not on the agenda.

## Conclusion

**Jerome Powell's change of communication completely displaced Christine Lagarde's comments on the need to maintain rates at a restrictive level for long enough. The markets still anticipate significant rate cuts from central banks: 5 rate cuts in 2024 for the Fed, including the first in May, and 5 rate cuts for the ECB by October 2024, including the first in April. This turns out to be excessive given the risks of more persistent inflation than anticipated by markets.**

**Aline Goupil-Raguénès**

## Market review

# The Fed uncorks the Champagne

**Brutal rally across all asset classes as the Fed discusses the timetable for rate cuts. The ECB and the BoE, despite their more cautious stances, seem incapable of stopping the rally.**

The sudden change in the Fed's monetary policy stance is the major event of the end of the year on the financial markets. When the Fed moves, the other central banks also see themselves constrained by a new monetary backdrop. Jerome Powell, who on December 1st argued that it was premature to talk about monetary easing, now concedes that the discussions focus on the timetable for interest rate cuts. Across the Atlantic, both Andrew Bailey and Christine Lagarde are, however, seeking to temper market enthusiasm as market participants demand rapid rate cuts. This implicit validation of market pressure sounds like a dangerous bet in the face of still high inflation. It also amplifies the general rise in asset prices which sweeps away concerns about the alleged tightening of financial conditions. It also ignores the current economic situation of the US economy, the scale of the fiscal stimulus and the low level of unemployment (3.7%). We will never know if political pressure or the hypothetical return of Donald Trump is now forcing the Fed to rush monetary relief. The size of the Treasury debt refinancing constitutes another sword of Damocles affecting the repo market. Despite economic fundamentals in line with Fed objectives, the tensions that occurred in September 2019 sparked intervention by the Fed in the form of T-bill purchases. In early December, the SOFR rate approached 5.40%. This is perhaps the trigger for this change in monetary stance. If this is the case, the question of the end of the quantitative tightening policy will quickly arise.

In this context, economic data releases have little impact on markets, which remain obsessed with the prospects of easier liquidity conditions. However, markets will have to deal with the amortization of the PEPP from the second half of next year and the continued reduction in the ECB's balance sheet. Rising retail sales or low levels of new jobless claims seem to invalidate fears of a sharp slowdown in the US economy. However, PMI surveys in the Eurozone remain weak. Furthermore, Chinese economic data remains mixed with a slowdown in consumption and a favorable surprise in industrial production, which appears to be Xi Jinping's new priority.

Looking at fund flows, investors are returning to stocks in force with inflows of $25 billion over the past week. The financing comes from money market funds where outflows reached $31 billion globally last week. Market performance reflects a form of bullish capitulation across all risky assets. On US equity markets, the Russell 2000 ignored by investors until early November is now up 13% in 2023. Hedge funds also seem to be repositioning onto European equities.

Bond yields collapsed to 2.04% on the Bund and 3.90% on the T-note. The relative firmness of the ECB caused a flattening of the German curve while the US curve steepened beyond 5 years. The euro area debt agencies published their 2024 financing programs. France will issue €15 billion more in 2024 for a gross total of €285 billion. Ireland with a budget surplus will maintain its presence to the tune of €6-10 billion next year. Finally, the EU will borrow €75 billion in the first half of the year and will make greater use of auctions to minimize the cost of financing with deal sizes of up to €25 billion. Sovereign spreads welcomed the late start of the cutback of PEPP reinvestments with some relief. Italy, which is trading below 170 bps again, will benefit first and foremost from the flexibility of the PEPP program.

The bull backdrop also pertains to the credit market where spreads plunged by 6 to 8 bp over a week. The absence of primary market activity combined with the return of credit fund inflows is fueling the narrowing in spreads. Risky segments such as real estate and banking AT1s are taking full advantage of the resumption of risks, even if it means calling into question the valuation levels reached today, particularly in high yield. The iTraxx crossover is trading less than 330 bp as protection buying is unwound. The high yield bond market is not to be outdone with spread narrowing by around 30 bp over the past week. Stocks are jumping particularly in the United States as small caps, which lagged considerably this year, gained 7%.

**Axel Botte**

## Main market indicators

| G4 Government Bonds | 18-Dec-23 | 1wk (bp) | 1m (bp) | 2023 (bp) |
|---|---|---|---|---|
| EUR Bunds 2y | 2.54% | -17 | -42 | -22 |
| EUR Bunds 10y | 2.07% | -20 | -52 | -50 |
| EUR Bunds 2s10s | -48bp | -4 | -10 | -27 |
| USD Treasuries 2y | 4.43% | -28 | -46 | +0 |
| USD Treasuries 10y | 3.94% | -29 | -49 | +7 |
| USD Treasuries 2s10s | -48.9bp | -1 | -4 | +7 |
| GBP Gilt 10y | 3.71% | -37 | -39 | +4 |
| JPY JGB 10y | 0.68% | -9 | -3 | -21 |
| **€ Sovereign Spreads (10y)** | **18-Dec-23** | **1wk (bp)** | **1m (bp)** | **2023 (bp)** |
| France | 53bp | -3 | -4 | -1 |
| Italy | 168bp | -12 | -10 | -46 |
| Spain | 97bp | -6 | -5 | -11 |
| **Inflation Break-evens (10y)** | **18-Dec-23** | **1wk (bp)** | **1m (bp)** | **2023 (bp)** |
| EUR 10y Inflation Swap | 2.14% | -4 | -19 | -41 |
| USD 10y Inflation Swap | 2.46% | +2 | -10 | -7 |
| GBP 10y Inflation Swap | 3.58% | -7 | -17 | -33 |
| **EUR Credit Indices** | **18-Dec-23** | **1wk (bp)** | **1m (bp)** | **2023 (bp)** |
| EUR Corporate Credit OAS | 138bp | -6 | -9 | -29 |
| EUR Agencies OAS | 70bp | -1 | -3 | -9 |
| EUR Securitized - Covered OAS | 78bp | 0 | -3 | -6 |
| EUR Pan-European High Yield OAS | 401bp | -26 | -52 | -111 |
| **EUR/USD CDS Indices 5y** | **18-Dec-23** | **1wk (bp)** | **1m (bp)** | **2023 (bp)** |
| iTraxx IG | 62bp | -5 | -7 | -29 |
| iTraxx Crossover | 334bp | -35 | -49 | -140 |
| CDX IG | 58bp | -4 | -6 | -24 |
| CDX High Yield | 366bp | -37 | -44 | -118 |
| **Emerging Markets** | **18-Dec-23** | **1wk (bp)** | **1m (bp)** | **2023 (bp)** |
| JPM EMBI Global Div. Spread | 389bp | -8 | -39 | -64 |
| **Currencies** | **18-Dec-23** | **1wk (%)** | **1m (%)** | **2023 (%)** |
| EUR/USD | $1.093 | 1.496 | -0.128 | 2.1 |
| GBP/USD | $1.267 | 0.892 | 1.296 | 4.8 |
| USD/JPY | JPY 143 | 2.324 | 3.886 | -8.2 |
| **Commodity Futures** | **18-Dec-23** | **-1wk ($)** | **-1m ($)** | **2023 (%)** |
| Crude Brent | $78.6 | $2.5 | -$2.0 | -2.7 |
| Gold | $2 025.2 | $43.2 | $47.1 | 11.0 |
| **Equity Market Indices** | **18-Dec-23** | **-1wk (%)** | **-1m (%)** | **2023 (%)** |
| S&P 500 | 4 719 | 2.49 | 4.55 | 22.9 |
| EuroStoxx 50 | 4 533 | -0.17 | 4.42 | 19.5 |
| CAC 40 | 7 573 | 0.28 | 4.68 | 17.0 |
| Nikkei 225 | 32 759 | -0.10 | -2.46 | 25.5 |
| Shanghai Composite | 2 931 | -2.03 | -4.05 | -5.1 |
| VIX - Implied Volatility Index | 12.46 | -1.35 | -9.71 | -42.5 |

Source: Bloomberg, Ostrum AM

## Additional notes

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