MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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Four topics for 2023

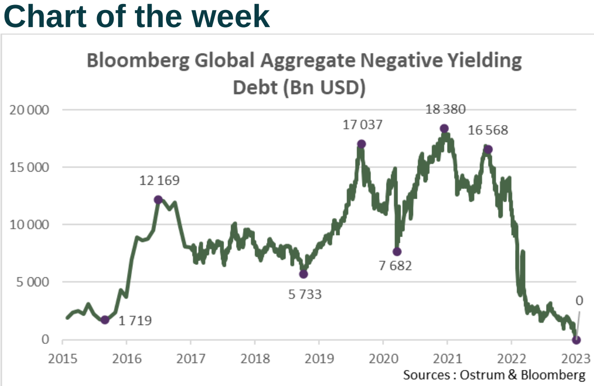
Like last year, each of us is presenting a topic that we think is crucial to monitor this year. We would also like to take the opportunity to wish you a very happy new year.

- **High supply of sovereign bonds and ECB's QT will converge to create risks for the sovereign market;**
- **Financial fraud is a late-cycle phenomenon. The fraud cycle tends to follow the economic slowdown;**
- **China, after three years of isolationism, the world's second economic power is finally opening and in force!**
- **Liquidity risks linked to the continued tightening of monetary policies and the stronger presence of non-banks.**

Market review: The Fed's dilemma

- **Fed officials confronted with easing of financial conditions;**
- **Euro area core inflation (5.2%) keeps rising;**
- **Notable pickup in European stock inflows;**
- **Fixed income markets absorb a flood of issuance.**

Chart of the week



End of an era!

The volume of negatively yielding debt amounted to more than 18 trillion in 2021 and was still above 14 trillion at the end of 2021. This week it went back to zero for the first time since early 2010. The JGB mar-2024 was the last bond to reach a zero yield.

Negative debt evaporated last year in Europe and the recent moves by the BoJ has resulted in JGB moving back into positive territory. The drop has been quite impressive indeed and illustrates the scale of the change we went through since the beginning of last year.

Figure of the week

4

Source : Ostrum AM

France is the fourth country out of 76 in the MIT's "Green Future Index country ranking".
Indisputably, much remains to be done, but France scores quite well indeed.

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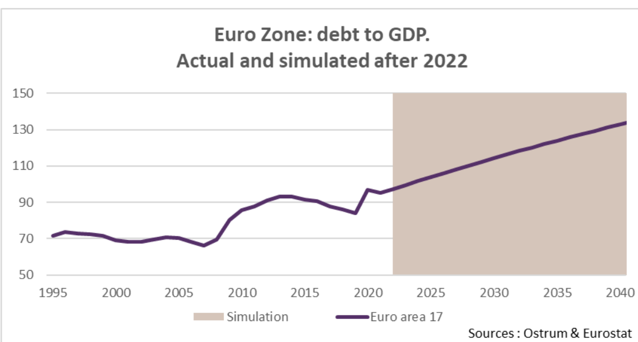
Topics of the week #1

Sovereign crisis?

The rapid deterioration of public finances, the large volume of issues in 2023 and the introduction of QT are a particularly indigestible cocktail for markets.

Sustainability of public finances

The public deficit of the Eurozone countries was 5.1% in 2021, a deficit that should not really be reduced in 2022 with all the activity support programs that have been put in place. A simulation of the debt-to-GDP trajectory gives the following chart. It is a simulation, assuming that fiscal policy does not change, that growth is on trend and that rates are not moving. The resulting “spontaneous trajectory” leaves no room for doubt: this trajectory is exponential and therefore not sustainable in the long term. States will have no choice but to reconsider a more rigorous policy.



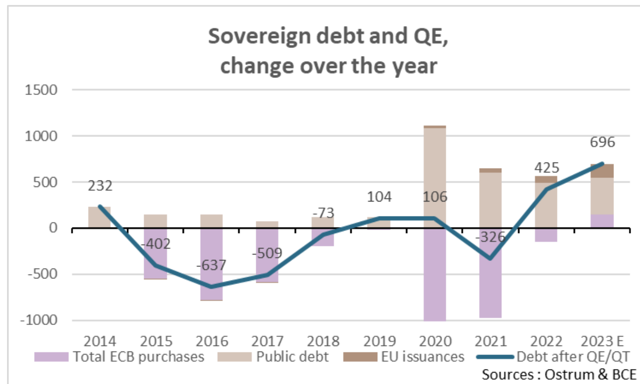
However, it should be noted that the situation, as always, is very mixed for countries. In particular our simulations show a downward trajectory for Portugal’s debt and, to a lesser extent, for Ireland. On the other hand, the spontaneous trajectory of France is particularly dynamic, that of Italy and Spain are also to be watched.

While the unemployment rate is at an all-time low, and therefore the output gap is positive, such a deficit is more than worrying. However, the efforts made are very limited and the return to a more reasonable trajectory will, at best, take time.

Issuances

In terms of public debt issuance, the year 2023 could therefore be more than complicated. Our estimate of the area’s deficit is in the order of 400 Bn, a figure close to the estimates of net borrowing made by various banks. In addition to this figure, the EU has almost 150 Bn emissions to finance its programs, which is much higher than in previous years.

Finally, the action of the ECB must be added to this picture. Since 2015, the ECB has purchased €4.246 billion of sovereign bonds through its various QE programs. Over the same period, sovereign debt increased by $3.013 billion. The ECB therefore bought more than the total net issuance, hence it has de facto financed the deficit of the euro zone during the past 8 years.



The announcement of the QT is therefore a real turning point for the markets, with 15 Bn per month from March, the ECB would therefore return 150 Bn to the market over the year.

Between the needs of the different governments, the EU issuances and the QT, it is therefore about 700 Bn that the markets must swallow, a very strong increase compared to the last decade.

Conclusion

The psychodrama in Britain in September after the presentation of Liz Truss' somewhat lunar budget has been in the spotlight. But is Europe completely immune? Admittedly, budgetary policies are far from Ms Truss' escapades, but the trajectory is equally worrying and the pressure put on the markets in terms of the need for financing is unprecedented. The risk of an accident is not negligible, where the market is no longer able to absorb all this paper.

One solution would be to close the QT or, as a last resort, to re-open QE. That would put us back in full “fiscal dominance” where fiscal policies twist the arm to the ECB and force it to implement a suboptimal monetary policy. With inevitable consequences for inflation and an unavoidable loss of credibility.

Stéphane Déo

Topics of the week #2

Fraud as the late-cycle risk

Asset prices are the harshest prosecutors. Economic downturns tend to uncover fraud cases and expose unsustainable corporate structures. The cycle of fraud tends to follow the business cycle: the longer the expansion, the worse the wave of fraud. Wrongdoing can take many forms ranging from Ponzi schemes, 'creative' accounting, and the abuse of metrics aimed at misrepresenting the underlying financial reality.

Crypto collapse

The speed of unravelling of the crypto world is daunting. Market frothiness was always a warning sign, but corporate governance issues were indeed central to the demise of the digital token sector. Sam Bankman-Fried, the founder of the now collapsed FTX token exchange, went on air calling business models of yield farming outright Ponzi games as in 'put money in a box, more money comes out and worry later'. As always, collected fees from unsuspecting investors eventually slow down and the pyramid collapses. It is interesting how the cases for holding cryptocurrencies have evolved in the past few years. Cryptocurrencies have alternatively been pushed as a store of value, an inflation hedge, an anti-fiat structure... only to hide the fact that they are merely speculative assets. Several stable coins failed to hold the collateral required to be… stable against their fiat counterpart, i.e., the almighty US dollar.

Now a legitimate question would be whether the unravelling of cryptocurrencies, non-fungible tokens and similarly speculative assets including SPAC or meme stocks, have the potential to spread to broader financial markets. Can the US Tech complex be unsettled by the fallout of the crypto universe? As it stands, there may still be hundreds of billions of dollars' worth in crypto assets.

Meanwhile money-losing investors and even crypto CEOs have started to call for 'regulation' and prosecute the bad guys hidden in the Bahamas or Dubai. Calling for regulation and all kinds of government support inherent to fiat currency systems is the ultimate irony for the crypto world claiming to part ways with fiat and decentralize finance. Anyway, public outcry for 'justice' after the tide has turned is not new. The failures of Enron or WorldCom brought about the Sarbanes-Oxley Act of 2002 that established sweeping auditing and financial regulations for public companies.

The inflation of financial metrics

Besides greed-enabled Ponzi schemes, there is another area of concern, namely 'creative' accounting. The widespread (ab)use of metrics to mask over bad business plans. One must wonder whether the SEC in the US and other market regulators would eventually crack down on accounting tricks. Adjusted EBITDA all too often takes out true operating costs. Companies taking 'one-off' restructuring charges every year for long stretches are other examples of dishonest accounting as charges are indeed recurrent. Likewise, WeWork's 'community-adjusted' EBITDA is not a problem until it is. EBITDAC, i.e before 'Coronavirus', made way into pitch books around 2021 to tweak debt multiples lower.

Below-the-line items also require scrutiny. As financial markets often reward growth over profitability (as in the 2021 non-profitable Tech hype), compensation of managing directors has evolved. Share-based compensation has become commonplace but may not be considered operating expense. Share-based comp runs parallel to share-buyback programs. In bad times with downward pressure on stock prices, keeping compensation in dollar terms unchanged requires massive share issuance, which is then pro-cyclical. This is equivalent to granting managers put options on the firm's value. The run rate of share-based compensation has been a concern in some instances, potentially offsetting share buyback programs. It also embeds the wrong incentives, not to play it safe in terms of corporate investment projects. And incentives do matter. Tesla's share-based compensation is estimated to represent around half of its proforma EPS. It should be clear that share-based comp is an expense or a form of hidden leverage.

The warning signals of fraud

Detecting fraud is not easy. But there seems to be a pattern of corporate decline with markers to observe. A multi-year downtrend in the stock price is a given marker. A lower resilience to turbulence and low degree of internal control should entail warnings for investors. Obviously, an abrupt change in auditors, as seen in European real estate recently, is a negative signal.

The obsession for size in the context of declining operational leverage (i.e. the ability to turn revenue into profit) may lead to non-core acquisitions predicting corporate failures. Overstatement of revenue growth may signal such lack of operational leverage.

Management tenure is also a two-edge sword. Short tenures (0-4y) are ineffective as managements are too focused on share prices. Entrenched management teams with mandates above 10 years is also problematic empirically. The sweet spot is 4-10 years. Sudden exits of top management are another flag. Complexity of acquisition deals, especially with related parties, can hint at funneling money out of the company. In fraud cases, CFO pay has been a better predictor than CEO's.

Conclusion

Big fishes rising to the surface is a distinctive late-cycle feature. The financial fraud cycle is a stylized fact of the later stages of the economic cycle. Financial information, when it is partial, misleading, or asymmetrical, always ends up being sanctioned… and the toughest prosecutors are undoubtedly the financial markets.

Axel Botte

Topics of the week #3

China opening : what impacts ?

After three years of isolationism, the world's second economic power is finally opening and in force! Xi Jinping intends to strengthen his leadership internationally. This will not be without consequences for the global economy.

Rising commodity prices

China opening should change the behavior of the energy market which until now has been governed by supply. Demand is expected to be the main market mover in 2023. As a result, the IEA increased its forecast for Chinese oil demand growth to 820,000 bbl/d, up 5.5% from 2022 and up 2.5% from 2021. Chinese crude oil imports in November were down 1.4% from November 2021. The risk is therefore a rise in crude oil prices that would revive inflationary fears at the global level, forcing central banks to tighten their monetary policies further.

2022 was also marked by a drop in industrial metal prices, such as aluminum (-15.3%), zinc (-16%) and copper (-13.6%), which are also green metals as they are involved in the composition of renewable technologies. After a year of continued price increases in 2020/21, prices fell due to fears of a global recession linked to the war in Ukraine. Representing 50% of global metal consumption and production, China is therefore important for this market. A stabilization of its real estate market, the Chinese authorities' objective, could support base metal prices in 2023. In addition, other support factors could also support their prices: the acceleration of the green transition in developed countries to reduce their dependence on fossil fuels, and the Inflation Reduction Act in the United States that facilitates the green transition for American businesses. The downside risk to this scenario is a global recession.

Reducing dependence on the dollar

China has never hidden its ambition to make the yuan an international reserve currency, just like the dollar. However, the road is still long as China still controls its yuan, and the Chinese currency is not fully convertible. In contrast, China wants to increase the use of the yuan in trade regulations and cross-border investments to reduce its dependence on the dollar and maintain access to global markets during geopolitical crises. To convince its trading partners to use the yuan as a settlement currency, China allowed its currency to be converted into gold.

At their recent summit in Uzbekistan, members of the Shanghai Cooperation Organization (CSO), led by China and Russia, agreed to develop trade in local currency. China has already signed bilateral currency exchange agreements with several CSO members since 2011, including Uzbekistan, Russia, Tajikistan, Kazakhstan, and Pakistan. These bilateral foreign exchange swaps are denominated in yuan and the counterparty currency, allow the Chinese Central Bank counterparty to access liquidity in yuan for a short period and at relatively low interest rates in exchange for its own currency as an implicit guarantee. With the other member countries, trade in yuan is more limited. However, this trend could quickly reverse since the outbreak of the war in Ukraine, which has led several countries to consider alternatives to the dollar, especially those vulnerable to US sanctions. Thus, Belarus requested to be a full member of the CSO while it was an observer member. The United Arab Emirates, Bahrain, and Kuwait have officially become CSO dialogue partners. Egypt, Qatar, and Saudi Arabia have already registered as dialogue partners. The emergence of regional hubs using the yuan in trade regulations provides China with a cushion against the isolation of the West and to ensure its geo-economic security.

Towards the Petro yuan in 2023

China is seeking to de-dollarize the energy market by imposing the yuan as the reference currency.
Since the outbreak of the war in Ukraine, China has increased its imports of Russian oil, accounting for more than 17% of its total crude oil imports in 2022, neck and neck with Saudi Arabia. In 2021, Saudi Arabia (17%) was China's largest crude oil supplier, followed by Russia (15%) and Iraq (11%). China settles its deliveries of Russian crude in yuan, and Russia uses these yuan to buy Chinese technology products. India is also considering a similar mechanism to settle its Russian oil deliveries in rupees.

At the China-Gulf Cooperation Council Summit held on December 9, 2022, in Riyadh, Xi Jinping also proposed to the Gulf countries to sell their oil and natural gas on its platform, the Shanghai Petroleum and National Gas Exchange, and in yuan! Saudi Arabia, like other Gulf countries, has anchored its currency to the dollar, which implies having large dollar reserves to defend its peg. The country will continue, "for the moment", to use its oil revenues to buy American government bonds. However, Saudi Arabia could accept that part of its crude oil exports to China be denominated in yuan as a means of strengthening its cooperation with China. Around $50 billion worth of investment agreements were signed during Xi Jinping's visit,

the Saudi Investment Minister said to Bloomberg.
The foundations of a new energy order between China and the Gulf countries are underway. If Petro yuan were to expand, there would be significant economic consequences worldwide. China would then control the energy market by setting prices, which could be an inflationary factor for other countries, especially the especially western countries. The birth of Petro yuan should encourage Europeans to accelerate the transition of their economies towards renewables to reduce their dependence on fossil fuels.

Conclusion

China is opening with a clear desire to de-dollarization the world economy, imposing its yuan on its trading partners. A new energy order was born in Riyadh, which will have consequences for the world economy. China wants to control the energy market, which is inflationary for Western countries.

Zouhoure Bousbih

Topics of the week #4

Market liquidity risks

The continued tightening of central bank monetary policies, in a context of increased presence of non-banking institutions in the financial markets, could accentuate the decline in liquidity observed in 2022. This poses a threat to financial stability that could lead central banks to urgently intervene to provide needed liquidity.

Sharp drop in liquidity

In 2022, the liquidity of the main sovereign bond markets has decreased significantly. It has been at its lowest in the United States since March 2020, since 2010 in Germany and 2011 in France, the United Kingdom and Japan. However, these markets are essential to financial stability given their key role in the financing of States, their status as a safe haven in the event of stress on the markets. They also serve as a reference in setting the price of other assets (equities, corporate bonds), as collateral for many transactions (securitizations, etc.). Added to this is their role in monetary policy through massive purchases by central banks to ease financial conditions. Liquidity also deteriorated on the corporate bond market but also on the MBS market in the United States.

Monetary policy uncertainties

This decline in liquidity was accompanied by an increase in volatility, reflecting the uncertainty linked to the greater than expected monetary tightening carried out by central banks in order to curb inflation. These will continue to hike rates and reduce the size of their balance sheets in 2023, thus weighing more on liquidity.

Disengagement of banks in favor of non-banks

Another explanatory factor is linked to the decline in the presence of large banks in particular in bond markets, in the MBS market and the financing of mortgage loans, to the benefit of non-banking establishments. The share of the latter in global assets has increased significantly to represent nearly 50% in 2021, according to the Financial Stability Committee. This is notably the result of reforms carried out after the global financial crisis of 2008/2009 to strengthen the financial system, including an increase in capital requirements to cover potential losses on bonds. This has made it more expensive to hold Treasury, which has resulted in a decline in the presence of banks in this market.

The share of hedge funds and, more recently, high-frequency trading firms in the US bond market has increased markedly. The same is true of the MBS market and that of American mortgage loans, with a strong presence of non-banks. However, these establishments are much less regulated than banks and have different operating methods.

Financial stability risk

Hedge funds incorporate much higher leverage and less liquid strategies. In times of stress, such as March 2020, they were forced to unwind their positions, by selling their bonds, to meet margin calls. This added to the pressure on rates, forcing the Fed to intervene. In the event of a shock, the sudden withdrawal of high-frequency trading companies also contributes to the drop in liquidity on the bond market.

These liquidity risks posed by non-banks in times of stress were also brought to light last September in the United Kingdom. To respond to margin calls following the strong tensions on rates, pension funds had to sell government bonds massively and thus accentuate tensions on rates, forcing the Bank of England to intervene urgently.

The OECD recently warned of the liquidity risks posed to pension funds in the event of a financial shock due to the increase in investments in illiquid assets (infrastructure projects and private equity). The IMF, for its part, is concerned by the risk of illiquid assets held by open-end funds.

Conclusion

The uncertainty linked to the continuation of monetary tightening by central banks and the growing presence of non-banking institutions in the financing of crucial markets, accentuate the risks of liquidity in the event of new pressures on rates or any other stress. Urgent reforms are needed to improve the functioning of markets and reduce risk. In their absence, central banks will need to act urgently to preserve financial stability.

Aline Goupil-Raguénès

Market review

The Fed's dilemma

The Fed struggles to get its restrictive message across, global bond yields fall despite a deluge of credit and sovereign debt issuance, equities outperform in the euro area.

Inflation is, to varying degrees, the #1 enemy of financial assets. The rapid decline in consumer prices in the euro area is immediately reflected in a sharp rebound in both equities and bonds. The Euro Stoxx climbs 4% and yield curves are inverted again under the weight of buying interests in long-term bonds despite a deluge of sovereign and credit debt issuance last week. The December FOMC minutes nonetheless give a glimpse of the dilemma facing central bankers at this juncture, as monetary tightening is partly canceled out by the broad-based easing of financial conditions. Employment remains very solid in the United States and wage dynamics make a lasting slowdown in prices towards the inflation target quite doubtful. In Asia, the reopening of China reflects the primacy of the 2023 growth objective for the government despite the difficulties in containing the Covid epidemic. In Japan, the defense of the 0.50% cap on 10-year JGB yields is forcing the BoJ into massive purchases, which is fueling volatility on the dollar-yen in the short term. The Japanese currency touched 130 before falling back to 134 at the end of the week.

The December FOMC minutes highlight the dilemma facing US central bankers. Inflation is indeed decelerating. Market participants see monetary easing as early as the end of 2023. On the contrary, the Fed's rate projections point to a 75-100 bp hike ahead of an extended restrictive status quo. The myopia of the markets reacting to the latest CPI figures is not surprising, but it is counterproductive for the Federal Reserve, which must ensure that inflation returns to the 2% target. The cyclical fall in energy prices is also expansionary and the dynamism of the labor market is still pointing to strong wage gains that is probably inconsistent with a lasting lull in consumer prices. Job openings once again exceeded expectations in November (10.4 min) so that the sum of job vacancies and employment remains well above the labor force. The labor supply shock is in fact a very long-lasting phenomenon. In December, net hiring amounted to 228k according to the NFP employment measure, a slightly higher number than the ADP estimate (+182k). Wages keep rising, and households will benefit this year from the review of the income tax scale which will add 1pp of real disposable income. Growth in 4Q 2022 is probably between 3 and 4% on an annual basis. The December ISM reading below 50 is however a warning signal.

In the euro area, the decline in consumer price inflation, amplified by the energy relief bill in Germany in particular, is a welcome development as it considerably reduces the likelihood of a severe recession. The resilience of economic activity is now reflected in most activity surveys. However, the fall in headline inflation to 9.2% in December (flash estimate), masks the continued acceleration in core inflation (5.2%). The ECB is therefore unlikely to deviate from its restrictive policy stance in the short term.

The debate on the terminal policy rate is not yet established as a central theme for financial markets in the euro area. The Euro Stoxx 50 soared 4% with very strong gains for banking stocks and cyclical sectors. On the other hand, the US equity markets, held back by the hawkish December FOMC minutes and jobs data, were less upbeat although the service ISM reading did boost shares. According to EPFR mutual funds data, outflows from US equity funds ($5bn, including a sharp selling bias in US technology) are redeployed towards money market funds ($112 in inflows) and bond funds. Layoff announcements among the US technology mega-caps have been weighing on equity indices, but the earnings season should remain quite solid overall.

As regards fixed income, 10-year yields reversed the end-of-year correction to the upside. The Bund yield fell sharply by nearly 35 bps to reach 2.20%. The December steepening movement reverses again so that the 2s10s spread is back to its 2022 lows at -37 bps. However, the primary market was very busy with Portuguese (15-year bond at MS +75 bps) and Irish (20-year green) bond syndications largely oversubscribed and EIB and OAT deals, just before EU bond issuance this week. Sovereign bond spreads tightened last week. The OAT is trading around 50 bps while the BTP is trading close to 200 bps. The increase in the net financing requirement of governments and the imminence of the QT start in March nevertheless may call into question the tightening of spreads.

In the United States, the comments of the central bankers after the publication of the FOMC minutes revived the trend for further inversion in the yield curve. The 2-10 year spread has plunged from -48 bps on December 28 to -71 bps currently. The negative carry on long-term bonds does not discourage investor interest for US bonds. Demand for US Treasuries from non-resident investors remains strong despite the sizeable cost of currency hedging.

The euro IG credit market had to absorb a deluge of bond issues last week. Financial bond issuance is off to a start this year but non-financial bond issues may catch up with €8-13bn supply expected this week. Spreads widened slightly (+1 bp) in a broadly risk-friendly environment highlighted by the sharp narrowing of spreads in high yield space (-25 bps last week). Indeed, the iTraxx crossover (448 bp) began 2023 on very strong footing with spread tightening of 28 bps.

Axel Botte

Main market indicators

G4 Government Bonds	09-Jan-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.62%	-9	+46	-14
EUR Bunds 10y	2.25%	-19	+32	-32
EUR Bunds 2s10s	-37.6bp	-9	-14	-17
USD Treasuries 2y	4.23%	-20	-11	-20
USD Treasuries 10y	3.57%	-30	-1	-30
USD Treasuries 2s10s	-66.4bp	-11	+11	-11
GBP Gilt 10y	3.53%	-15	+35	-15
JPY JGB 10y	0.51%	+8	-8	+0
€ Sovereign Spreads (10y)	**09-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	50.69bp	-3	-4	-4
Italy	199.15bp	-12	-14	-14
Spain	105.96bp	-2	-2	-2
Inflation Break-evens (10y)	**09-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.34%	-13	-27	-21
USD 10y Inflation Swap	2.46%	-7	-11	-7
GBP 10y Inflation Swap	3.64%	-27	-10	-27
EUR Credit Indices	**09-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	169bp	+2	-5	+2
EUR Agencies OAS	77bp	-2	-6	-2
EUR Securitized - Covered OAS	81bp	-3	-12	-3
EUR Pan-European High Yield OAS	505bp	-7	-24	-7
EUR/USD CDS Indices 5y	**09-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	79bp	-11	-10	-11
iTraxx Crossover	416bp	-56	-44	-58
CDX IG	73bp	-9	-7	-9
CDX High Yield	442bp	-43	-32	-42
Emerging Markets	**09-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	469bp	+17	+2	+17
Currencies	**09-Jan-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.073	0.591	1.803	0.2
GBP/USD	$1.219	1.204	-0.555	0.9
USD/JPY	JPY 132	-0.804	3.564	-0.6
Commodity Futures	**09-Jan-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$80.8	-$5.1	$4.2	-5.99
Gold	$1 877.7	$53.6	$80.3	2.94
Equity Market Indices	**09-Jan-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 914	1.95	-0.51	1.9
EuroStoxx 50	4 055	5.17	2.86	6.9
CAC 40	6 895	4.55	3.25	6.5
Nikkei 225	25 974	-1.39	-6.91	-0.5
Shanghai Composite	3 176	2.81	-0.96	2.8
VIX - Implied Volatility Index	21.63	-0.18	-5.26	-0.2

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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