MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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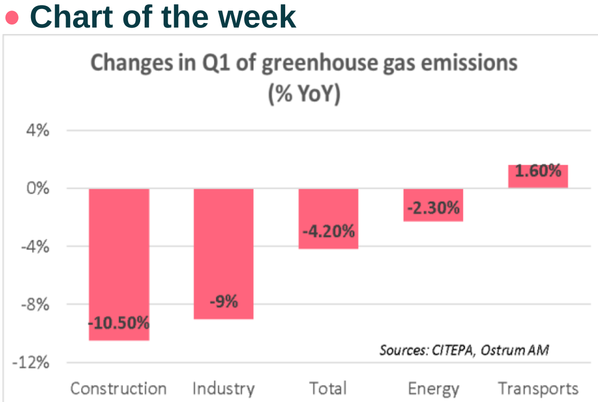
Topic of the week: Emerging Markets: Desync!

- **Rapid declines in inflation rates, high nominal interest rates and low currency volatility have paved the way for lower rates for emerging markets;**
- **We favour local debt in Brazil and Mexico over Eastern European countries with slower disinflation process;**
- **The de-synchronization of the emerging markets' monetary policies also reinforces the value of diversification.**

Market review: The Fed is right

- **Jobs and surveys justify Fed tightening ;**
- **US 10-Yr note yield rises above 4 %;**
- **Credit spreads resist despite upward pressure on CDS indices;**
- **European equities dip as yields shoot higher.**

Chart of the week



In the first quarter of 2023, greenhouse gas emissions fell by 4.2% over one year and those of CO_2, the best covered by the CITEPA barometer, by 4.9%.

We are approaching the pace required to achieve the European "Fit for 55" objective. But part of the declines can be explained by cyclical factors, while emissions from transport remain on the rise.

Figure of the week

15

Source : Bloomberg

It took fully 15 years for US 2-Yr note yield to rise back to 5%.

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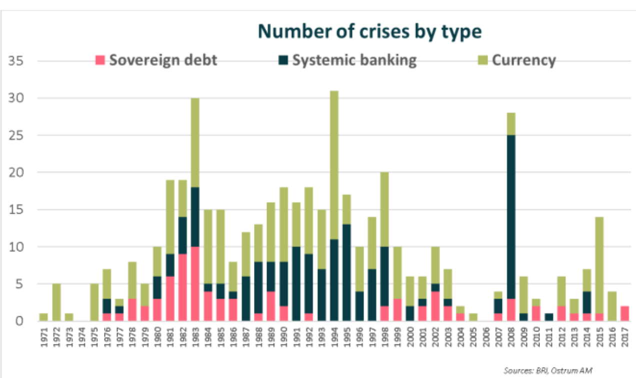
Topic of the week

Emerging Markets: Desync !

Despite the aggressive tightening of monetary policy by the Fed, most emerging market currencies held up well, if not better than those of advanced countries. Thus, the Brazilian real or even the Mexican peso (our main bets since 2022) have recorded performances of more than 8% and 11% against the dollar since the start of the year! Towards a paradigm shift for emerging markets?

Lessons from the past...

Historically, high inflation and financial stress have always moved hand in hand for emerging markets. The chart below, taken from the annual report of the Bank for International Settlements, shows the occurrence of financial crises since 1971.

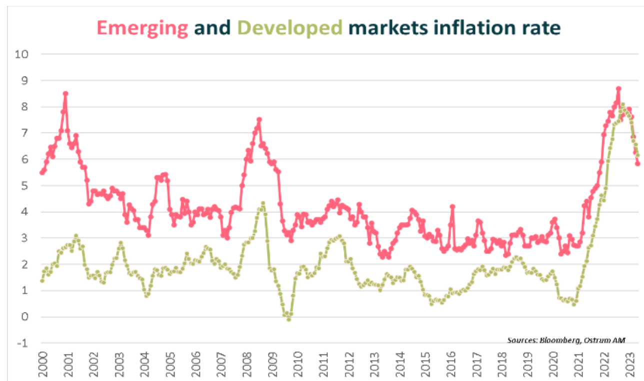


The crises were particularly numerous during the 1980s and 1990s, marked by hyperinflation in Latin America. We can also note the coincidence of the three crises: sovereign, banking, and currency. Indeed, major financial crises are often characterized by a "doom loop" between the balance sheet of the sovereign and that of the private sector. In this case, fiscal and financial instability reinforce each other, the banking sector suffers losses on its holdings of government bonds, while the government must strengthen the failing banking system. In turn, these budgetary and financial crises weaken the currency, exacerbating the situation. However, it is interesting to note that the number of financial crises, particularly in emerging countries, has been reduced since the 2000s (apart from 2008), reflecting the strengthening of the institutional framework in these countries. This time around, high inflation in emerging countries did not translate into financial strains as in the past.

… Have borne fruit!

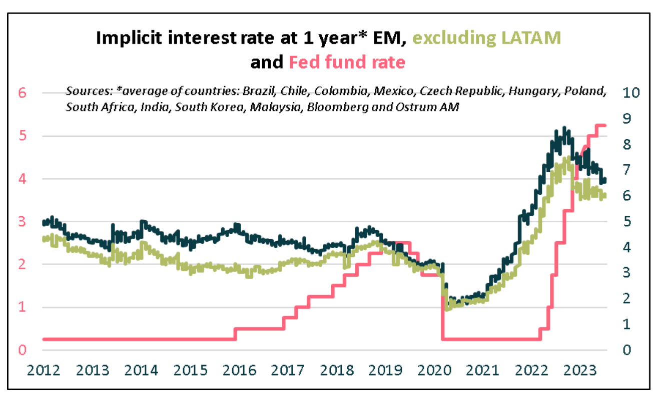
Peak on inflation…

Inflation in emerging countries has already shown significant progress. The following graph shows the inflation rate of the 18 main emerging countries and that of the developed countries.



For the first time, inflation in emerging countries is lower than in developed countries and is falling faster. In Brazil, inflation (3.9% in May) has already converged well below the Brazilian Central Bank's target of 4.5%. Ditto for Indonesia and Thailand, which have succeeded in converging their inflation rates within the target band of their central banks.

This rapid fall in inflation is explained by the responsiveness of central banks in emerging countries, which began their rate hike cycles in March 2021, i.e., before the Fed, as shown in the chart below.



Central banks in Latin America were the first to raise their key rates, and aggressively so, as the chart shows. Their history of hyperinflation, as we have seen previously, allowed them to anticipate the cycle of high interest rates well.

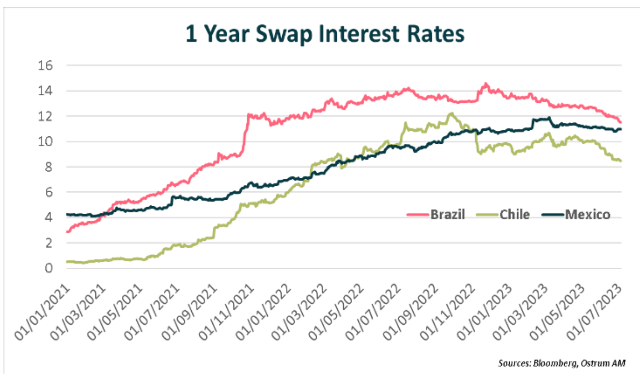
In addition, the central banks of emerging countries have managed political pressure well, like the Central Bank of Brazil (BACEN) which resisted pressure from Lula, who wants a drop in the Selic rate to support the country's growth.

BACEN had thus maintained its restrictive bias, because of the uncertainty about the new government's budgetary policy, fearing an increase in public spending and a drop in tax revenue that could fuel inflationary pressures. Coordination between monetary and fiscal authorities has also enabled central banks in emerging countries to fight inflation effectively.

… And peak on the terminal rate

Many central banks in emerging countries no longer need to wait for the end of the cycle of Fed rate hikes to begin their cycle of interest rate cuts. Like the Central Bank of Hungary, which has already started to lower its main key rate to 16%, the highest rate in the European Union, indicating further rate cuts for the coming months.

Central banks in Latin America are also well positioned to begin their cycle of monetary easing. The two Central Banks of Brazil and Chile should be the first to lower their rates, as shown by the 1-year swap interest rates on the chart below.



In Chile, the 1-year swap interest rate has returned to its April 2022 levels at 8.4% (the current key rate is 11.25%). The Central Bank of Chile has clearly mentioned the start of a drop in its interest rates. Aggressive rate hikes penalized Chilean economic activity, which did not benefit from the reopening of China through the rise in copper prices. The Central Bank of Chile has also indicated that it wants to pay back its foreign exchange reserves, which have reached nearly 4 billion dollars, or 11.5% of GDP, the lowest ratio compared to other Latin American countries. The goal is to increase them by 25% to $10 billion. The appreciation of the peso reflects the improvement in the terms of trade, and the Central Bank of Chile is comfortable with the current level of parity around 800.

The Central Bank of Brazil has raised the possibility of a cut in its Selic rate as early as August, reflecting the rapid progress on inflation. The 1-year swap interest rate reached its level of December 2021 at 11.5%.

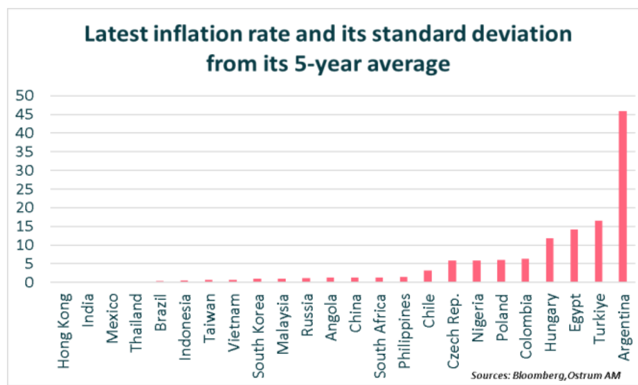
The Central Bank of Mexico (Banxico) has signaled a pause in its monetary tightening cycle. Unlike its neighbours, the 1-year interest rate swap does not indicate marked expectations of rate cuts. The Banxico generally follows the Fed, to preserve its currency. The central banks of Taiwan, India, Indonesia and Poland also signaled a pause in their monetary tightening cycle.

Peak on inflation and the terminal rate: what opportunities?

Falling inflation, high nominal interest rates, and low currency volatility paved the way for rate cuts for central banks in emerging countries. This should benefit the local sovereign debt of the latter. In this part, we identify investment ideas on local sovereign debt.

Disinflation is faster in Brazil and Mexico than in Eastern European countries

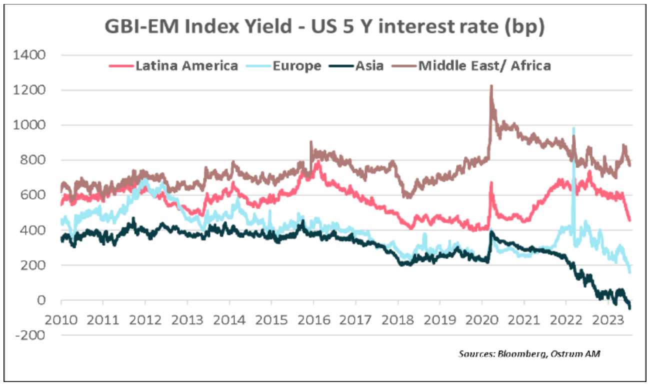
The chart below shows the latest inflation rate and its standard deviation from its 5-year average.



Progress on inflation has been rapid for Brazil and Mexico, unlike Argentina, Colombia, or Chile. Eastern European countries, such as Hungary, Poland, or the Czech Republic, still have inflation rates that remain historically high and should decline more slowly. We therefore favor the local debt of Brazil and Mexico over that of Eastern European countries.

Stretched valuations are the principal risk for carry trade strategies...

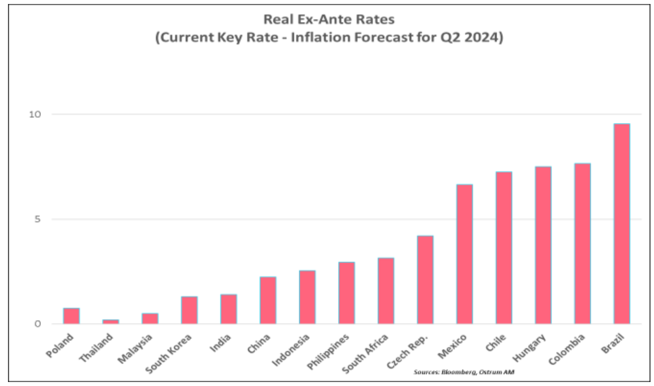
The graph below shows the rate differential against the US 5-year interest rate.



Overall, June was characterized by a decline in the local sovereign debt risk premium. Latin America's risk premium has returned to its 2021 levels, after remaining at levels above the pre-Covid period for a long time. Valuations therefore appear stretched for local debt and constitute the main risk for carry strategies.

… But an interest rate differential that remains attractive

Nevertheless, emerging central banks should remain cautious, in a context where their counterparts in advanced countries reiterated, in Sintra, the maintenance of their hawkish bias. The graph below shows the ex-ante real interest rates, i.e., the difference between the current policy rate and the inflation forecast for the second quarter of 2024.



The monetary policy remains highly restrictive in Brazil, Colombia, Hungary, Chile, Mexico and the Czech Republic. Thus, the interest rate differential should remain favorable for local sovereign debt.

Conclusion

Emerging markets have learned lessons from the past and are in pole position to begin their cycle of interest rate cuts. Local sovereign debt should therefore continue to outperform the debt of advanced countries. Latin America, which started raising its key rates in March 2021, remains the best positioned. We continue to favor local sovereign debt in the region, such as Brazil and Mexico, over countries in Eastern Europe which are on a slower disinflation process. The main risk is the valuation which is already stretched. However, the caution of central banks in emerging countries should keep the interest rate differential attractive, still benefitting carry strategies.

Zouhoure Bousbih

Market review

The Fed is right

The bond bullish consensus is seemingly proven wrong by the economic data releases which validate the Fed's scenario. European equities are down but credit is holding up.

Economic data publications remain quite upbeat in the United States. The rebound in the activity survey for the service sector and the strength in US employment fully justify the monetary tightening announced by the Fed even as policymakers opted for a pause in June. The hawkish turn glimpsed in the statements of central banks materialized this week by a surge in government bond yields. The yield on 10-year T-notes broke through the 4% ceiling after the ADP showed strong job gains in the US. The Bund yield is also back above 2.60%. This acceleration to the upside triggered a stock market correction which eventually stabilized at the end of the week after a 4% price drop in Europe. However, monetary tightening is outweighing the good news on US economic growth, especially since the performance of the first half of the year has sparked some profit-taking on equities. The euro-dollar exchange rate hovers around $1.09 whilst the Japanese yen’s weakness fades to a degree. Sovereign spreads are widening again but credit markets remain better oriented despite protection buying on credit default swap indices.

After strong evidence of a housing recovery came out last week, the job market confirmed the good health of the US economy. The reduction in layoff plans, particularly in the technology sector, or the drop in unemployment claims were already giving positive signals. Job creation remained solid at 209k in June, although downward revisions applied to April-May data or the gap with the stellar ADP release (+497k) may raise some questions. The backdrop remains an economy operating at full employment with the unemployment rate down again to just 3.6% in June. Average hourly wages are marginally revised up (+4.4%). Hours worked rose mirroring the decline in announced layoffs. The Fed was undoubtedly right to highlight the need for two additional rate hikes for 2023. The June pause will come down in history as an error of judgment without any real consequences given the likelihood of rate hikes in the coming month. In the euro area, the PMI surveys predict a downturn in economic activity (the composite index is below 50) but the rebound in factory orders in Germany seems, on the contrary, to point to an exit from recession. In China, the decline in the services PMI (53.9 in June after 57.1) only highlights the disappointing recovery so far.

The bond markets therefore corrected sharply last week. Key thresholds were crossed, such as the 4% mark on the US 10-year note yield or 2.50 % on the German Bund. The bond-bullish consensus since 3.70-3.75% on the 10-Yr T-note is undermined. In a way, the burden of proof of an upcoming recession is on the US bond buyers. The 2-year US bond yield also hit 5% before drifting lower again (around 4.94%). Speculative accounts, on the other hand, maintain a strong short bias. The US bond yield curve remains quite inverted. That said, the unwinding of flatteners are taking place so that the 2-10 year spread rose by 17 bps in the past week. This rebuilding of a term premium seems to validate both the inflationary risk and the possibility of an increase in Treasury bond issuance size from August. The German Bund market followed suit. The Schatz yield is nevertheless stabilizing around 3.25% while the 10-year rate was trading around 2.63% on Friday. As in the United States, the yield curve steepened again on Friday as equity markets pared their losses. Job data in Canada added to the uptrend on the local 10-year yields (+27 bps). Gilts, which suffers from the BoE's credibility deficit, also underperformed. At the other extreme, the firm hands of the BoJ and the PBoC kept a lid on bond yields.

Sovereign spreads also reacted to the rapid rise in risk-free rates. The Bund above 2.60% requires a higher premium over the 10-year OAT (55 bps) or the BTP (174 bps). The very long bond issues in France or Spain were not well received by market participants given the bear bond market backdrop on Thursday. All sovereign spreads nevertheless remain near the bottom of their 2023 range.

The credit market trend remains more favorable despite the challenging context in markets in Europe, at least for government bonds. Euro IG credit spreads were down by 6 bps to 157 bps with a slight outperformance of financial bonds, no doubt helped by higher interest rates. High yield spreads also tightened by 10 bps. The good high yield performance is notable given the protection buying flows observed in the CDS space. The iTraxx Crossover spread is trading around 420 bps at the end of the week (+17 bps). It is worth noting that the CDS market sometimes foreshadows turnarounds in the less liquid corporate bond market.

The main European equity indices have plunged 3-4% this week due to tensions on long-term interest rates. The downward price adjustment is painful but short covering at the end of the week kicked in as bond yields eventually stabilized at high levels. The caution of institutional investors, which remain underweight equities, also seems to provide a floor for the equity markets. In the United States, the benchmark equity indices nevertheless rose, including the large-cap growth stocks that are supposed to be most sensitive to higher long-term rates.

Axel Botte

Main market indicators

G4 Government Bonds	10-Jul-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.29%	+3	+37	+52
EUR Bunds 10y	2.65%	+21	+27	+8
EUR Bunds 2s10s	-64bp	+19	-10	-43
USD Treasuries 2y	4.9%	-3	+31	+48
USD Treasuries 10y	4.03%	+17	+29	+15
USD Treasuries 2s10s	-87.8bp	+21	-2	-32
GBP Gilt 10y	4.65%	+21	+41	+98
JPY JGB 10y	0.46%	+6	-5	-20
€ Sovereign Spreads (10y)	**10-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	56bp	+2	+2	+1
Italy	173bp	+3	+5	-40
Spain	105bp	+5	+6	-3
Inflation Break-evens (10y)	**10-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.53%	+0	+13	-2
USD 10y Inflation Swap	2.59%	+1	+10	+6
GBP 10y Inflation Swap	3.9%	-1	+9	-1
EUR Credit Indices	**10-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	158bp	-5	-9	-9
EUR Agencies OAS	77bp	-1	-1	-2
EUR Securitized - Covered OAS	88bp	+0	+3	+5
EUR Pan-European High Yield OAS	458bp	+2	-8	-54
EUR/USD CDS Indices 5y	**10-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	76bp	+2	-2	-15
iTraxx Crossover	411bp	+10	+1	-63
CDX IG	69bp	+2	-2	-13
CDX High Yield	446bp	+11	+3	-38
Emerging Markets	**10-Jul-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	434bp	+2	-19	-18
Currencies	**10-Jul-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.097	0.559	2.008	2.5
GBP/USD	$1.280	0.804	2.286	5.9
USD/JPY	JPY 142	2.125	-1.461	-7.4
Commodity Futures	**10-Jul-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$78.3	$3.6	$3.6	-5.8
Gold	$1 922.4	$0.8	-$35.4	5.4
Equity Market Indices	**10-Jul-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 410	-0.90	2.60	14.9
EuroStoxx 50	4 265	-3.02	-0.57	12.4
CAC 40	7 152	-3.17	-0.84	10.5
Nikkei 225	32 190	-4.63	-0.23	23.4
Shanghai Composite	3 204	-1.24	-0.86	3.7
VIX - Implied Volatility Index	15.24	12.14	10.20	-29.7

Source: Bloomberg, Ostrum AM

Additional notes

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