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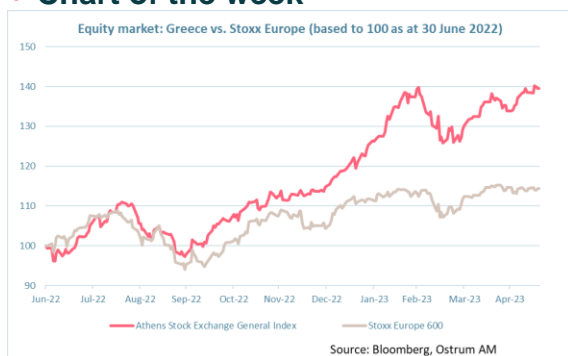
● Topic of the week: Debt ceiling: the clock is ticking.

- The US debt ceiling has been hit in January. The Treasury cannot borrow funds in the market so that failure to pay existing bills could occur as soon as June 1;
- House Republicans demand \$5 trillion spending cuts over 10 years as Biden seeks an increase in the debt limit with no strings attached;
- Treasury bills maturing before June 1 trade at sharply negative spreads to OIS;
- In the debt ceiling crisis of 2011, the US was downgraded to AA- by S&P sending equities lower and bonds and other safe haven (gold, currencies) higher;
- Whilst unlikely, a US default would have immediate consequences for American households and global investors.

● Market review: Mega caps pull markets higher

- Markets hope for a debt ceiling deal;
- Speculative positioning remains short both equities and bonds;
- US 2-year yields up to 4,20% as 10-year notes near 3.70%;
- Subordinated financials rally in the wake of stocks.

● Chart of the week



Between 2009 and 2012, Greece went through an unprecedented economic depression as GDP shrank by a quarter. After a decade of painful reforms and debt restructuring, the Greek economy appears to be on a recovery path. Greece's sovereign rating could be raised back to investment grade status in the coming weeks (Fitch on June 9th).

As the recovery gathers pace, Greek equity markets are outperforming the Stoxx Europe 600 index. The performance gap is 25% since June last year.

● Figure of the week

1,259

Source : EY

The number of foreign direct investments projects in France in 2022, the highest total in Europe. Foreign investment may create 38k jobs.



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● **Topic of the week**

Debt ceiling : the clock is ticking

The clock is ticking since the US hit its debt limit in January. The US Treasury may run out of cash by June 1. The 2011 rating downgrade due to a debt ceiling crisis provides a possible template for market reaction going forward. Other factors were at play then, but there could be lessons to be learned from the summer of 2011.

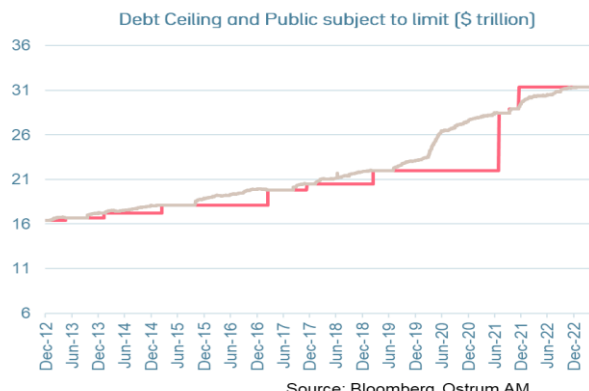
What's the debt ceiling?

The debt ceiling is an oddity. There does not have to be a debt limit. The debt ceiling is a cap on US government borrowing affecting the ability of the federal government to pay existing bills. The US government may approve a budget in deficit but be deprived by Congress of the authority to borrow.

There are 'ideas' to get around the debt limit. President Joe Biden could invoke the 14th Amendment of the US Constitution, which guarantees the validity of public debt, as a 'solution', basically making the cap unconstitutional. The US Treasury could mint \$1 trillion platinum coins and place them with the Fed to keep spending. But none of the above have been seriously considered.

In 2011, Standard & Poor's downgraded the US government's rating. Then-President Barack Obama, agreed to more than \$2 trillion in spending cuts over a decade to end the crisis. Still, two years hence, the cap was suspended for the first time.

The US hit the current federal debt limit of \$31.4 trillion in mid-January. Since then, the US Treasury has been using extraordinary measures (for instance withholding contributions to a federal employee retirement fund) to delay the day of reckoning. That moment, the 'X-date', when extraordinary measures will be exhausted, could arrive by early June. The actual default date could be days or weeks later.



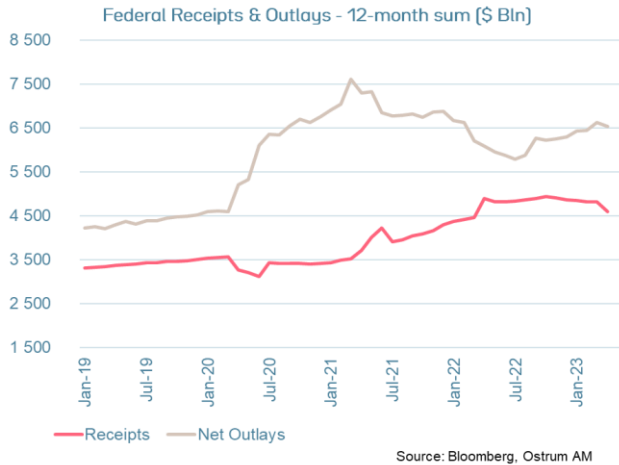
Upon default of the US government, many domestic and foreign institutions holding Treasury securities and American households including Social Security recipients, members of the military or families with children would be affected. There could be a partial shutdown of government agencies. Failure to pay bondholders would also have cascading effects, with credit rating agencies downgrading Treasury debt, raising costs and the availability of borrowing in all sectors of the US economy.

The debt limit must be raised. Leaders from both sides of the aisle recognize it. Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit. But, over time, it has become a recurrent political weapon. House Republicans led by speaker Kevin McCarthy wants to pair an increase in the debt ceiling with cuts in federal outlays. On April 26th 2023, House Republicans passed a bill that would raise the debt ceiling by \$1.5 trillion in exchange for \$4.8 trillion in budget deficit cuts over 10 years. The divided Congress means that the bill has no chance of making it through the Senate where Democrats hold a majority. A deal must be struck.

Playing with fire as X-date looms large

The X-date is believed to fall around June 1. The Treasury general account (TGA) is published weekly by the Fed. The TGA is running on empty with less than \$200 billion left. For reference, government spending may fetch \$500-600 billion a month.

The federal budget outturn in April (a big month in terms of tax collection) was disappointing with a smaller-than-expected surplus. The bigger shortfall so far in 2023 compared with last year appears partly due to lower capital gain tax receipts after the 2022 market rout.



Market impact of debt ceiling crisis

Markets around the US rating downgrade in 2011

In 2011, S&P downgraded the US by one notch from AAA to AA+. On July 14th, 2011, the rating agency announced that US debt was placed on negative watch and on August 5th the downgrade was formally announced despite the increase in the debt limit on August 2nd. Meanwhile, the situation in the euro area was dire. The banking crisis was in full swing and sovereign bond markets were teetering in the wake of a second 25 bp rate hike by the ECB on July 7th, 2011. Eventually, the ECB would launch the SMP (securities markets programme) in early August as Italy came close to losing market access. Italian 10-year BTP spreads widened by more than 150 bps in this period.

Financial markets thus moved wildly during the debt ceiling crisis. The S&P 500 equity gauge was down 16% on August 19th from its average level between the June close and the eve of the negative watch warning (July 14th). The US 10-year bond yield fell from 3.06% on average in early July to a low of 2.06% in middle of August. In turn, 1-month T-bill rates rose about 5 bps to 0.20% following but rallied after the ceiling was raised to less than 0.10%. The 1m-3m rate spread increased in the rally. In currency markets, the dollar lost 2% on a broad basis but was especially weak against the Swiss franc (-13%) and to a lesser extent the Japanese yen (-5%). Gold rallied the most gaining more than 23%. The 1-year US CDS premium went as high as 80 bps before rallying to the 30-bp area following the increase in the debt limit. Inflation expectations fell due to the rally in long-term bonds.

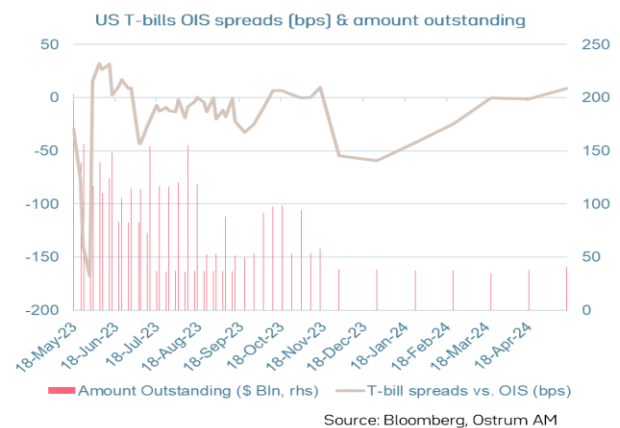
2011 debt crisis : Maximum drawdown/move/spread widening from June 30 - Jul 13 average after negative watch warning

S&P 500	-16%
Nasdaq	-14%
UST 10-year yield	-100 bps
US 1-month bill rate	-11 bps
1m3m yield curve	-8 bps
DXY Dollar index	-2%
Swiss Franc vs. USD	13%
Japanese Yen vs. USD	5%
Gold	23%
US Inflation swap	-35 bps
US 1-year CDS	25 bps
Italian 10-year BTP spread	159 bps

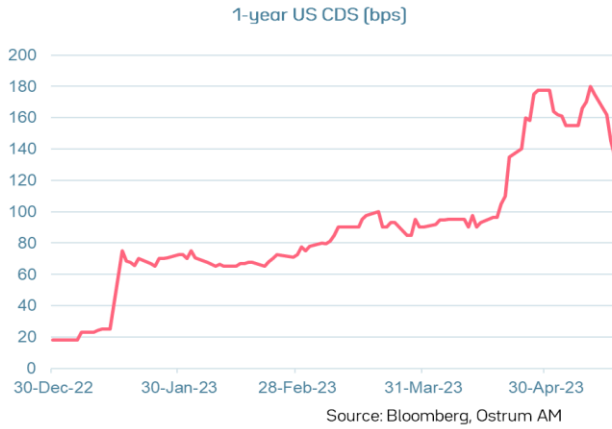
Source: Bloomberg, Ostrum AM

Current stress in US financial markets

According to Treasury Secretary Yellen, the X-date is June 1st. The estimated deadline has a considerable bearing on the pricing of Treasury bills. Bills maturing before the end of May are priced at very negative spreads against OIS swaps, which reflect expectations of secured overnight funding rates or SOFR. The bill maturing on May 30th is trading at -168 bps against OIS. Beyond the X-date, bill rates are higher than interpolated swap rates, reflecting a default risk premium. Even if the US failed to pay interest in full, the recovery value on defaulted US bonds would probably be very close to 100%. This is the reason why spreads are nowhere near distressed levels.



The credit default swap of the US is trading at much wider levels now compared with 2011. The CDS with a 1-year maturity is near 135 bps, down from 177-bp highs in early May. The larger premium is consistent with a greater risk of default of the US, although this credit protection instrument may have been used by investors as a hedge against the credit risk of US regional banks.



Financial hedges: few places to hide

Bloomberg ran a survey of more than 600 investors to get a sense of market reaction in the (still very unlikely) event of a US default. About 60% of survey respondents said the default risk is larger now than in 2011, the worst debt-limit crisis to date. The key takeaway is that there is a shortage of hedges. Investors would preferably revert to the oldest hedge in the book: gold. With gold trading above the \$2,000 threshold, the hedge is not cheap these days as central banks from the emerging economies load up on gold reserves in a bid to diversify reserves away from the US greenback. Ironically, the second most popular asset to buy was US Treasuries. The reason is that even pessimistic market participants expect bill holders to be paid in full – just late. Agency mortgage-backed securities would however be more affected by a US credit rating downgrade than

Treasuries. Currencies like the Japanese yen or even cryptocurrencies could represent alternative haven assets. Considering the recent stress on banks in Switzerland, the yen is arguably in a better position than the Swiss Franc to hedge out US credit risk.

Conclusion

The debt ceiling is economic nonsense and it has become a dangerous political weapon amid a divided Congress. House Republicans and President Biden are still in talks to raise the debt limit as the US Treasury is forecast to run out of cash by this end of the month. A US default would have immediate consequences for American households and global investors.

Whilst failure to pay remains unthinkable, a rating downgrade could hit US short-term debt securities, weigh on equity markets, and spur safe havens including gold and the Japanese yen.

Axel Botte

• **Market review**

Mega-caps pull markets higher

Hopes for a deal on the debt ceiling keep US mega caps pushing higher amid rate pressures

After the recent round of Central Bank meetings and the release of the US CPI, financial markets have found a new catalyst to move forward this week. Rumors of a debt ceiling deal this weekend are fueling a rebound in US equities led by the technology-sector mega caps. The concentration of stock market performance is striking such that the FANG index is up a whopping 6% this week. The ounce of gold dipped back under \$2,000. The bond market action also reflected an easing in market tensions. The increase in the US 2-year yield to 4.20-4.30% lifted the yield on 10-year T-notes up to about 3.70%. The German Bund yield is following the US bond market on the upside towards 2.50% resulting in a modest improvement in swap spreads (down -2 bps to 68 bps on 10-year tenors). Sovereign spreads are stable pending a possible Greek rating upgrade whilst Italy's rating goes under review. Credit is also upbeat which echoes the decline in implied volatility on equities. Risk premiums are decreasing across the board. The US dollar strengthened pushing the euro temporarily below \$1.08. Pressure is returning on the Japanese yen, which is trading again above 138 yen against the greenback.

As regards the economic backdrop, consumers continue to drive growth in the United States. Retail sales came out at a solid +0.4% in April. Excluding volatile items, household expenditure increased by 0.7%. The stabilization of housing transactions also hints at strong household demand. Homebuilder confidence indeed improved in May (NAHB survey at 50) and housing starts are now stable at around 1.4mn units on an annualized basis. The decline in home prices has stopped. The Philly Fed manufacturing survey (-10 after -31 in April) is encouraging though most manufacturing surveys remain mediocre. However, the second half of 2023 will be more difficult with zero growth at best. In the euro area, consumer price inflation was confirmed at 7% in April. Excluding energy and food, inflation stands at 5.6%. Employment expansion (+0.6%q) despite GDP growth of just 0.1%q in the first quarter implies a decline in apparent labor productivity which only adds to price pressures. Finally, data out of China are not as good as expected. Household consumption is well oriented (retail sales at +18% over one year) but less strong than expected, hence the chronic weakness of inflation. The recovery in industrial output is also fragile and signals from the housing sector remain unconvincing.

Economic uncertainty does not prevent equities from rallying. Negotiations in Washington seem to be moving forward, so that an agreement to end the debt ceiling crisis could be reached in the coming days. The S&P 500 gauge gained more than 1.5% hitting 4,200, but it is still the mega caps from the technology sector that are riding the AI theme and leading the market higher. The concentration of stock performance is not a good signal. The earnings season ended with US corporate profits down 2.8% year-on-year despite sales rising by 4%. The situations are nevertheless quite different from one sector to another. The stock market is protected by existing speculative short positioning. Non-commercial positioning is short 375k contracts on the S&P 500. Similarly, in Europe, the Euro Stoxx 50 is outperforming broader European indices. The DAX is at an all-time high. The volumes are nevertheless too narrow to fully validate a bullish acceleration.

Regarding fixed income, optimism in the marketplace is rekindling the risk of renewed Fed tightening. Several FOMC members have hinted that a pause in June could be followed by a further rate hike. Financial markets estimate that there is a one-in-three chance of a hike in June. This change in sentiment sent 2-year yields beyond 4.20% as CTA accounts amplified the upward trend on yields. This yield movement keeps volatility elevated on short-term bond maturities. The appropriate level of rates will also depend on the evolution of credit conditions across the US economy according to Fed chair Jerome Powell. The US 10-year note reacted to higher 2-year yields, approaching 3.70%. Like equities, speculative positions are clearly short, which may mean that the negative carry on bonds justifies keeping a cash allocation, especially since the premium on T-bills with a maturity greater than 1 month should deflate in the event of a debt ceiling deal. In the euro area, the Bund yield hit 2.50% during Friday's market session. The level of swap spreads remains abnormally high around 80 bps on 2-year maturities. In the United Kingdom, Gilts (4% at 10 years) reacted to a communication from the BoE suggesting an acceleration of QT outright sales.

Credit spreads are well oriented in the euro area, in particular for subordinated financial debt and high yield. The fund flows into IG credit funds have improved since the beginning of the month while we observe a slight decline in high yield fund flows. The primary bond market remains very active in high-quality credit. In addition to the €25 billion issued by sovereign, supranational and agencies, financial bond issuance total about €18 billion this week (euro-equivalent, mainly senior debt) with €13 billion coming from non-financial corporate borrowers. The high yield primary market is also getting more active without a negative impact on spreads. The ITraxx crossover is trading around 430 bps.

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● Main market indicators

G4 Government Bonds	22-May-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	2.79%	+19	-13	+3
EUR Bunds 10y	2.45%	+15	-3	-12
EUR Bunds 2s10s	-34.4bp	-4	+10	-14
USD Treasuries 2y	4.31%	+30	+13	-12
USD Treasuries 10y	3.7%	+20	+13	-17
USD Treasuries 2s10s	-60.6bp	-9	+1	-5
GBP Gilt 10y	4.04%	+22	+28	+37
JPY JGB 10y	0.39%	-1	-12	-13
€ Sovereign Spreads (10y)	22-May-23	1wk (bp)	1m (bp)	2023 (bp)
France	57bp	0	+0	+3
Italy	185bp	-3	-1	-29
Spain	105bp	-2	+0	-5
Inflation Break-evens (10y)	22-May-23	1wk (bp)	1m (bp)	2023 (bp)
EUR 10y Inflation Swap	2.44%	+4	-9	-12
USD 10y Inflation Swap	2.51%	0	-4	-3
GBP 10y Inflation Swap	3.69%	-1	-18	-21
EUR Credit Indices	22-May-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Corporate Credit OAS	171bp	+3	+16	+4
EUR Agencies OAS	83bp	+1	+7	+4
EUR Securitized - Covered OAS	92bp	+1	+6	+8
EUR Pan-European High Yield OAS	505bp	-6	+22	-7
EUR/USD CDS Indices 5y	22-May-23	1wk (bp)	1m (bp)	2023 (bp)
iTraxx IG	82bp	-5	-1	-9
iTraxx Crossover	430bp	-20	-10	-44
CDX IG	78bp	-2	+2	-4
CDX High Yield	489bp	-7	+17	+5
Emerging Markets	22-May-23	1wk (bp)	1m (bp)	2023 (bp)
JPM EMBI Global Div. Spread	482bp	-2	-4	+29
Currencies	22-May-23	1wk (%)	1m (%)	2023 (%)
EUR/USD	\$1.082	-0.616	-2.012	1.0
GBP/USD	\$1.243	-0.830	-0.313	2.9
USD/JPY	JPY 138	-1.726	-2.954	-5.3
Commodity Futures	22-May-23	-1wk (\$)	-1m (\$)	2023 (%)
Crude Brent	\$75.8	\$0.6	-\$5.7	-10.0
Gold	\$1 974.1	-\$46.2	-\$12.6	8.2
Equity Market Indices	22-May-23	-1wk (%)	-1m (%)	2023 (%)
S&P 500	4 192	1.49	1.56	9.3
EuroStoxx 50	4 392	1.54	-0.58	15.5
CAC 40	7 467	0.66	-1.45	15.3
Nikkei 225	31 087	4.93	8.83	19.1
Shanghai Composite	3 296	-0.43	-0.15	6.7
VIX - Implied Volatility Index	17.28	0.93	3.04	-20.3

Source: Bloomberg, Ostrum AM

Additional notes

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