Ostrum
ASSET MANAGEMENT

MyStratWeekly
Market views and strategy

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Topic of the week: An overview of the FX market.

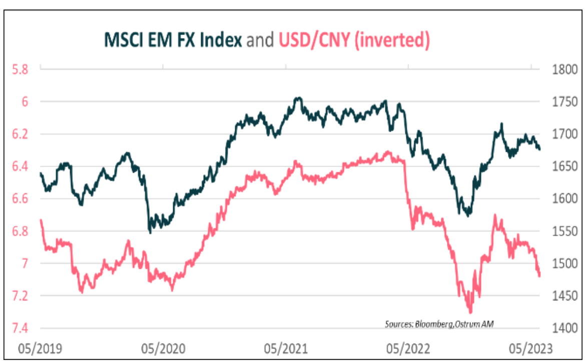
- **The evolution of the dollar will depend on the risk of recession, inflation, the crisis of regional banks and the debt ceiling;**
- **The euro seems vulnerable to an economic downturn, as well as a strong long positioning;**
- **The weak yen gives Japan a competitive advantage;**
- **The yuan should weaken to support Chinese exporters;**
- **The real and the Mexican peso offer attractive carry;**
- **Positive real rates should be the market mover for the FX market in this second part of the year.**

Market review: Fed: status quo called into question?

- **Markets fully price a 25-bp Fed hike in July;**
- **T-note yields hovering about 3.80%;**
- **Profit-taking on equities expect for US Tech;**

Stable credit spreads, sharp tightening in high yield.

Chart of the week



The Chinese yuan has massively underperformed the MSCI EM Currency Index.

Since May, the dollar has strengthened sharply in the wake of rising US nominal interest rates.

However, the Chinese authorities seem to tolerate the recent depreciation of the yuan against the dollar if it remains gradual and orderly.

The weakness of the yuan also supports exporters who are suffering from the contraction in manufacturing activity at the global level and the weakness of the yen.

Figure of the week

1.5

Source : weather agency

For the 1st time, the Earth's average surface temperature is likely to exceed pre-industrial temperatures by 1.5 degrees for at least one year before 2027.

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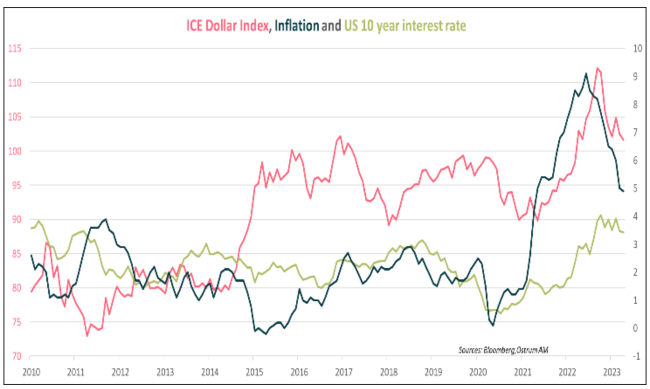
● **Topic of the week**

An Overview of The FX Market

This week, we take a quick look at the FX market, identifying investment opportunities.

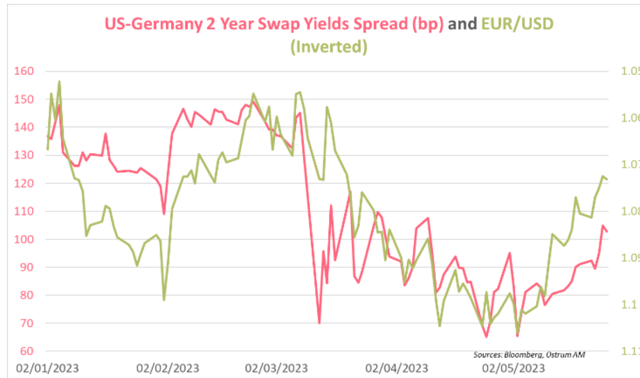
A peak for the greenback ?

The ICE dollar index seems to have peaked in October 2022, which also corresponds to a peak in inflation and in US long-term interest rates, as shown in the chart below.



The US dollar also benefits from safe haven status in the event of an increase in risk aversion in the financial markets. Four concerns currently dominate: the American recession, inflation, the crisis of American regional banks and the American debt ceiling.

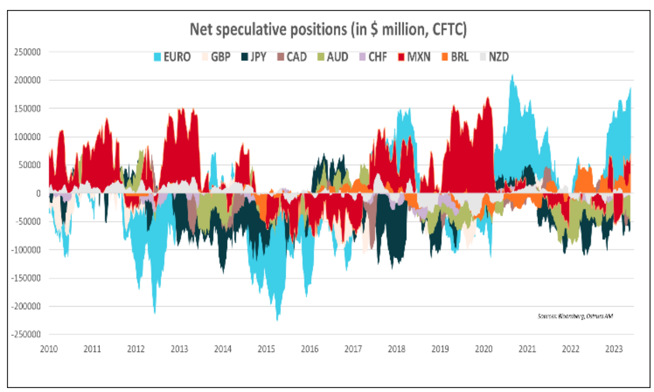
All these risks also have consequences for the trajectory of interest rates and therefore of the greenback. It is therefore difficult to systematically conclude that the dollar's role as a safe haven would result in an appreciation of the greenback against all the other currencies. The peak is more like a pause where investors, like the Fed, remain data dependent. In May, the greenback has strengthened, in the wake of the rise in the 2-year interest rate, which is back above 4%, driven by better-than-expected economic data. It is therefore not its role as a safe haven, but monetary policy expectations that explain the strengthening of the greenback, as indicated by the chart below.



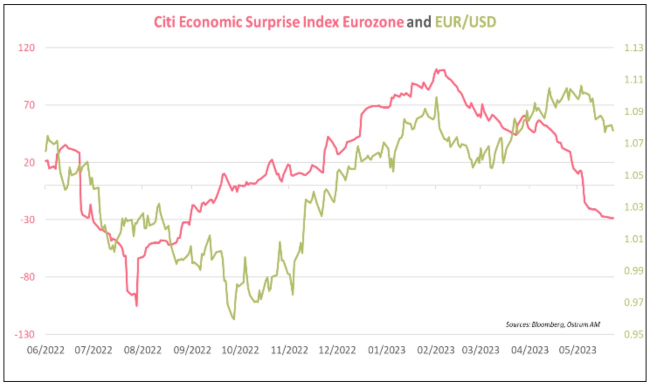
The 2-year swap interest rate differential between the United States and Germany widened, benefiting the dollar.

Euro: the worst is over, but…

The eurozone avoided recession, thanks to the fall in natural gas prices (now below €30/MWh, i.e. the lowest level since 2021), as well as government measures to cushion the energy shock on consumers and businesses.
The improvement in the growth outlook for the eurozone supported the single currency, which rose above parity against the dollar.
This resulted in a strong long positioning on the euro, as shown in the chart below, representing the net speculative positions (CFTC) on the main currencies.



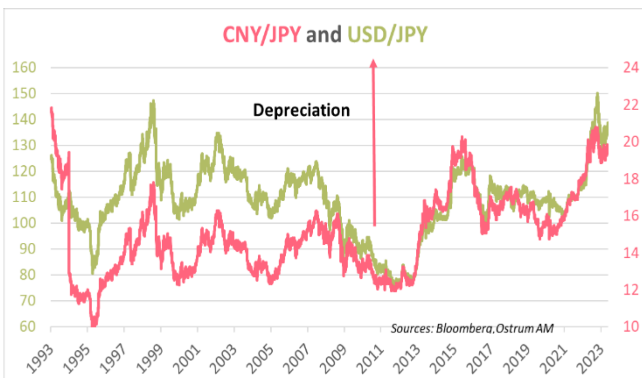
The euro is therefore the currency with the strongest buyer positioning among the main currencies. However, since April, the economic surprises in the zone have diminished, as shown in the following chart.



Thus, a deterioration in growth prospects as well as significant positioning, could put pressure on the euro against the greenback.

A devaluation of the yen?

The yen hit a 30-year low against the yuan, to a level near 20 The Japanese currency also depreciated against the greenback, near its lows reached in 1998, as shown in the next chart.

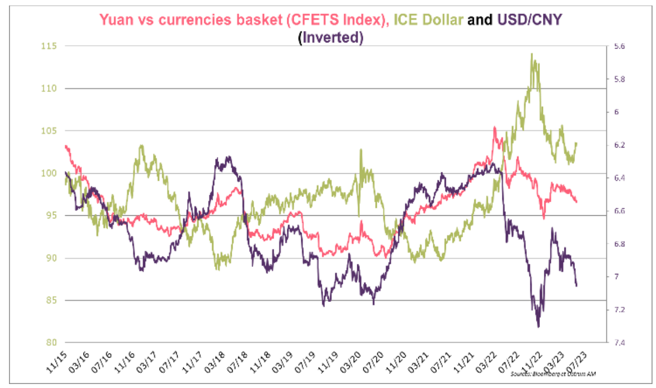


The weakness of the yen explains the good performance of the NIKKEI index, 17.68% since the beginning of the year, one of the best performances of the G20, just under the Nasdaq index (20%). Japan therefore has a significant competitive advantage to meet the infrastructure investment needs that are expected to increase in the region. According to the report *Infrastructure Financing in Asia* by the Asian Development Bank (ADB), emerging Asia needs to invest more than 5% of its GDP over the next decade in infrastructure. This represents more than 22.6 trillion dollars by 2030, or 1.5 trillion dollars per year!

The competitiveness of Japanese exports is the main reason why the BoJ is reluctant to exit its yield curve control policy because of the yen. The difference in monetary policy dynamics between the Fed and the BoJ could reverse and support the yen, which would penalize the competitiveness of its exports.

Regime shift for the yuan?

The Chinese currency seems to be initiating a change in trend. After reaching its lowest point against the dollar since 2015 in October 2022, the yuan appreciated against the greenback in the wake of the weakness of the American currency, but also in view of the opening of Chinese economy, as shown in the following chart.



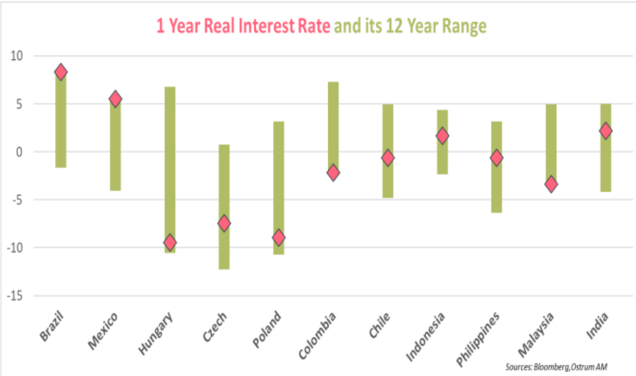
Since May, the dollar has strengthened, bringing in its wake the depreciation of other currencies, including the yuan.

However, the latter also depreciated against its basket of currencies. Meanwhile, the central exchange rate set by the PBoC has been held at a low since December 2022, suggesting the Central Bank's tolerance for recent weakness in its currency, if the move remains gradual and orderly. The post-“Zero-Covid” Chinese recovery is slow: it is therefore likely that the Chinese authorities wish to weaken the yuan to support exporting companies penalized by the weakness of the yen.

EM FX: attractive positive real rates

Nominal rates have been the main driver of the foreign exchange market so far, in the wake of global monetary tightening. However, several central banks in emerging countries are close to the end of their rate hike cycle, or even ready to ease their policy. Real interest rates will be the market mover in the foreign exchange market, potentially leading to divergences between currencies.

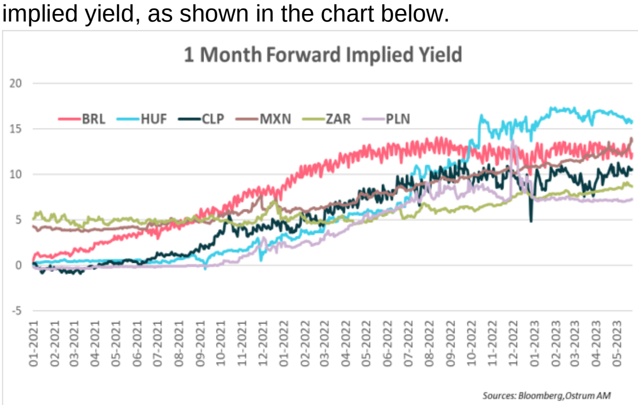
The chart below shows the real 1-year rate for several emerging countries and its evolution range over a 12-year period.



Brazil and Mexico already have positive and high real interest rates and a declining inflation profile. The real and the Mexican peso are our two preferred currencies in the Latin America region.

However, of these two, we give preference to the Brazilian real. The evolution of the real against the dollar has so far no connection with the fundamentals of its country. Indeed, in 2022, during the Russian invasion of Ukraine, the parity fell below 5, then went back above this level against a backdrop of US inflation and Fed rate hikes. Investors should focus on the country's improving fundamentals and support the real.

The Hungarian forint is also a preferred currency due to its high carry, at more than 15% according to 1-month forward implied yield, as shown in the chart below.



We remain constructive on this currency, which is sensitive to politic developments.

Conclusion

This quick overview of the FX market highlights 5 main trends:

- A pause for the greenback, the evolution of which will depend on 4 risks – recession, inflation, the crisis of American regional banks and the debt ceiling;
- The euro appears vulnerable to an economic downturn and strong investor positioning;
- The weak yen gives Japan a competitive advantage;
- The yuan should weaken to support Chinese exporters;
- Emerging currencies with positive real interest rates offer attractive carry.

Positive real rates should be the market mover for the second half of the year.

Zouhoure Bousbih

Market review

Fed: status quo called into question?

Debt ceiling deal looms, rates rise at the expense of equities except for US tech.

The political battle in the US Congress over the issue of the debt ceiling continues to fuel market volatility just days before the dreaded June 1 X-date. After Fitch put the US rating on negative watch, Moody's now says maintaining the Aaa will depend on the June 15 coupon payment. In this context, a debt ceiling bill could be voted by the House of Representatives on Tuesday before moving to the Senate on Wednesday. The hoped-for end to this self-inflicted crisis is accompanied by a rise in Fed interest rate expectations, driving the T-note yield towards 3.80%. At the same time, the Bund broke the 2.50% threshold. In the UK, stubbornly high inflation is add fueling to the global trend for higher bond yields. The Gilt tightened by 40 bps to 4.41%. The rise in interest rates sparked some profit-taking on equity markets but the optimism shown by US technology companies resulted in further outperformance from the Nasdaq. The recent sharp tightening of Greek, Portuguese and Irish sovereign spreads is holding up, while French OATs and Italian BTPs are not participating to the rally. Credit spreads are nearly unchanged while euro high yield is outperforming (-15 bps in Europe and -28 bps in the United States). The US dollar rebounded in the wake of Fed rate expectations at a time when the Japanese is showing renewed signs of weakness touching the level of 140 against the greenback. The euro weakens below $1.08.

As concerns the economic backdrop, the US economy grew by 1.3% in annualized terms between January and March. Household consumption is driving US growth, while business investment is slowing. The contraction in residential investment seems to be coming to an end. Household spending (+0.5% in real terms in April) is in line with the robust growth seen in the first quarter. Furthermore, the upward revision of the PCE deflator (+4.4% in April) will no doubt hold the attention of FOMC members. The increase in the debt ceiling will come with strings attached, as federal government expenditure will probably be frozen in 2024, slowing growth by 0.2 pp.

In the euro area, sustained activity in services contrasts with the sluggishness of manufacturing. This further penalizes Germany, which already experienced a recession between October and March. German GDP came out at -0.3% in the first quarter. The sharp decline in household consumption has accelerated, but, above all, it is the collapse in public demand that is most surprising (-4.9%). Paradoxically, business investment is rebounding despite a lackluster outlook according to the IFO institute. The Chinese economy is also showing signs of weakness, particularly in the industrial sector. The PBoC may decide on a further reduction in bank reserve requirements to try and stimulate aggregate demand.

The rise in bond yields is met with inflows into the asset class, a sign that current valuations entail support for bonds, which are experiencing their 9th consecutive week of inflows. Money market funds recorded additional inflows bringing the year-to-date to $756 billion. On the contrary, European and US equity funds face outflows with the exception of the technology sector funds. Investors remain quite cautious, even vis-à-vis rising markets as outflows also hit Japanese equities, for example. Final investors hence bank on the rebound in long-term rates. The US 10-year yield traded above 3.80% as a July rate hike is now fully priced into short-term rate futures after a pause in June. The rise in breakeven points reflects fears of more persistent inflation justifying additional monetary tightening and a sharper inversion of the yield curve. Inflation remains the all-important variable. In the United Kingdom, the CPI came out at 8.7%, half a point above consensus expectations. Disinflation, which appears much too slow, will force the BoE to keep tightening policy. As a result, Gilt yields are adjusting violently by more than 40 bps. In the euro area, Bund yields (2.50%) follow on from the global bond trend. Klaas Knot takes this opportunity to call for “at least” two new rate hikes. The 2-year yield is close to 2.90%, but with no effect on the swap spread, which remains at banking crisis levels (82 bp). Sovereign spreads are well in Ireland, Portugal and Greece, as market participants expect an upgrade of the Greek rating back to IG. Italy and France remain behind given current budgetary difficulties.

The corporate credit market has benefited from a return to inflows since the middle of the month. The primary market remains quite active with a total of €16 billion in non-financial issues and €13.2 billion in new financial debt. The spread on the euro IG stood at 170 bps against Bunds, unchanged from a week ago. Overall, valuations remain attractive on euro IG credit. Despite observed fund outflows, spreads on the high yield market are tightening sharply. The average spread has dipped below 500 bps against Bund. The risk of default remains moderate even if the credit crunch will primarily affect borrowers with lower credit quality. We forecast a gradual rise in defaults towards 3-4% on a one-year horizon.

Equities face profit-taking as interest rates race higher. European markets are down 3%. In the United States, the semiconductor sector adds to the outperformance of the technology group while all other sectors drop out.

Axel Botte

Main market indicators

G4 Government Bonds	30-May-23	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	2.81 %	-1	+12	+5
EUR Bunds 10y	2.37%	-10	+6	-20
EUR Bunds 2s10s	-44 bp	-9	-6	-25
USD Treasuries 2y	4.51 %	+19	+50	+8
USD Treasuries 10y	3.71 %	+2	+29	-16
USD Treasuries 2s10s	-80 bp	-17	-21	-25
GBP Gilt 10y	4.31 %	+15	+59	+64
JPY JGB 10y	0.44 %	+3	+4	+1
€ Sovereign Spreads (10y)	**30-May-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	57 bp	-1	-1	+2
Italy	182 bp	-3	-4	-32
Spain	105 bp	+0	+1	-4
Inflation Break-evens (10y)	**30-May-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi	273 bp	+2	-6	-
USD TIPS	225 bp	-3	+4	-4
GBP Gilt Index-Linked	371 bp	+9	+11	+9
EUR Credit Indices	**30-May-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	170 bp	+0	+8	+3
EUR Agencies OAS	82 bp	+0	+2	+3
EUR Securitized - Covered OAS	92 bp	+1	+1	+8
EUR Pan-European High Yield OAS	485 bp	+1	-19	-27
EUR/USD CDS Indices 5y	**30-May-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	79 bp	-2	-4	-11
iTraxx Crossover	422 bp	-11	-16	-52
CDX IG	75 bp	-3	-2	-7
CDX High Yield	471 bp	-12	+2	-13
Emerging Markets	**30-May-23**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	478 bp	-3	-16	+26
Currencies	**30-May-23**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.074	-0.3	-2.12	+0.28
GBP/USD	$1.242	+0.06	-0.55	+2.82
USD/JPY	¥139.87	-0.88	-1.71	-6.26
Commodity Futures	**30-May-23**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$75.9	-$0.9	-$4.4	-$8.3
Gold	$1 958.1	-$15.1	-$23.6	$134.1
Equity Market Indices	**30-May-23**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 205	0.32	0.86	9.53
EuroStoxx 50	4 329	-0.31	-0.70	14.11
CAC 40	7 266	-1.52	-3.00	12.25
Nikkei 225	31 328	1.20	8.57	20.06
Shanghai Composite	3 224	-0.68	-2.98	4.37
VIX - Implied Volatility Index	17.23	0.12	9.19	-20.49

Source: Bloomberg, Ostrum Asset Management

Additional notes

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