MyStratWeekly
Market views and strategy

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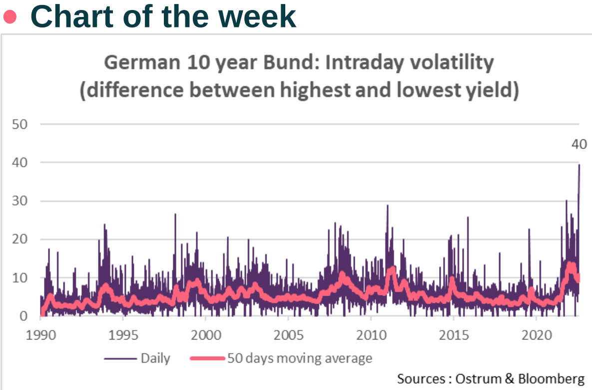
Topic of the week: Update of our forecasts

- **As of every quarter, during our investment committee process, we update our economic forecasts. Here we present this update;**
- **Our central scenario is a sluggish recovery with economies bordering on recession;**
- **The structuring element of our view is inflation as we expect underlying pressures to persist at a high level that should make central banks uncomfortable.**

Market review: A panic cycle

- **The ECB raised rates but offers no guidance for future moves;**
- **Financial developments will inform policy decisions;**
- **Unheard-of volatility in rates;**
- **Fed injects $165 Bn.**

Chart of the week



One of the caracteristics of last week's market turmoil is the unprecedented volatility in the bond market. Wednesday, the daily range of the Bund was 40 bp. This is totally unusual, the previous all time high since 1999 had been recorded on the 8th of August 2011 at 29 bp.

It is interesting to note that the MOVE index, which measures the expected volatility on the Treasury has also jumped to 200, close to its all time high. Paradoxically, the VIX remained below 30 showing clear signs of stress, but to a level considerably lower than what we witnessed in the bond market. Similarly volatility in FX remained relatively subdued.

Figure of the week

5.7

Source : Ostrum AM

Labor costs were up 5.7% in Q4 last year. The emergence of a wage/inflation spiral is now indisputable.

Stéphane Déo
Head of markets strategy
stephane.deo@ostrum.com

Axel Botte
Global strategist
axel.botte@ostrum.com

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

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

Topic of the week

Update of our forecasts

As of every quarter, during our investment committee process, we update our economic forecasts. Here we present this update.

Euro Area

We expected a very moderate recession in Q4 2022 and Q1 2023. The figures published for Q4 actually show a stabilization of the economy. On the other hand, the evidence for this year's Q1 shows growth, albeit low, but in all probability positive.

As a result, the growth carry-over at the end of 2022 was already 0.4%. With moderate growth, average growth over the rest of the year should therefore be in the 0.5/1.0% range.

The relative decline in inflation and the rise in wages, but also in government subsidies, should keep the purchasing power of wages at a very slightly positive level. Consumption would then be slightly upward over the year. Similarly, the accumulated investment lag should allow capex to progress, again moderately.

As a result, we have a GDP trajectory that is still mediocre but displays a little acceleration at mid-year. This puts us on the high side of the consensus.

A fundamental point in our forecast is the inflation trajectory. It's declining rapidly until this summer, largely because of the basic effects on the energy component. But the underlying part remains very stable and should not fall below 5% by the end of the year. This leads to a high year-end landing, above 5 % over the last quarter. This is fundamental to monetary policy.

Euro Area	2022				2023					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2022	2023
GDP (QoQ)										
Ostrum	0.6	0.9	0.4	0.0	0.2	0.4	0.4	0.3	3.5	1.1
Consensus					*-0.2*	*0.1*	*0.3*	*0.2*		*0.5*
Inflation										
Ostrum	6.1	8.0	9.3	10.0	6.3	6.0	5.8	5.6	8.4	5.9
Consensus					*8.0*	*6.3*	*4.7*	*3.1*		*5.5*
Core inflation										
Ostrum	2.7	3.7	4.4	5.1	5.3	5.2	5.1	5.1	3.9	*5.2*

USA et al.

Rising rates are a drag on growth, with the most directly exposed sectors, including real estate, showing very strong signs of slowing. While the figures available for the first quarter show, once again, a very resilient economy, on the other hand we think that the economy will approach recession at the end of the year.

The U.S. economy has shown an unusual ability to absorb rate hikes. We believe that structural changes explain this resistance. As a result, we think the “soft landing” scenario is more likely than the “hard landing” scenario.

The bankruptcies of SVB and Signature are a warning shot: we do not think this constitutes the beginning of a systemic crisis, the much more pessimistic alternative scenario can however be ruled out even if its probability is limited.

Finally, continued inflation above the Fed target remains the most likely scenario. Wage pressures in particular remain high. Again, this is a structuring element for the Fed.

It should also be noted that China is rapidly reopening. This implies more sustained global growth, an improvement in the latest production problems related to supply chains, but also new potential inflationary pressures on raw materials. The reopening of China therefore bears out the idea of growth that surprises upward, as well as inflation.

USA	2022				2023					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2022	2023
GDP (QoQ)										
Ostrum	-0.4	-0.2	0.8	0.7	0.5	0.3	0.0	0.0	2.1	1.5
Consensus					*0.1*	*-0.1*	*0.0*	*0.2*		*0.8*
Inflation										
Ostrum	8.0	8.7	8.3	7.1	2.6	2.6	2.7	2.7	8.0	2.7
Consensus					*5.8*	*4.1*	*3.5*	*3.2*		*4.2*
Core inflation										
Ostrum	6.5	5.9	6.6	5.7	3.0	2.5	2.4	2.4	6.2	*2.6*

Conclusion

Our central scenario is a sluggish recovery with economies bordering on recession. However, the consensus, which seems to be far behind, is lower than we are on these growth figures. So there is potential for upgrade.

The structuring element of our view is inflation as we expect underlying pressures to persist at a high level that should make central banks uncomfortable.

Market review

A panic cycle

The Fed and financial institutions take initiatives to mitigate the banking panic, but the volatility of interest rates remains considerable.

It is extremely rare to observe intraday movements of 60bp on the German 2-year and yet the Schatz traded at 3% on Wednesday morning then below 2.40% a few hours later. Years of unconventional policies had long masked this natural tendency to greater volatility in 2-year bonds compared to long rates. The return to so form of “normality” in the term structure of volatility is brutal. Moreover, the current situation reminds us that trust will always remain a bank's main asset. The banking panic in the United States is easing somewhat thanks to the use of Fed facilities. In Europe, the SNB offered CHF 50 billion to save Credit Suisse from a deleterious spiral. As often, the dynamics of a banking crisis appear unpredictable. The cash injected in emergency limited the correction or even allowed stock market gains on the Nasdaq (+3.3% this week). Long-term interest rates seem to concentrate all volatility. The yield on US 10-year notes is overall down around 30bp over the week to around 3.4%. The Bund yield is trading around 2.10% at the end of the week. Sovereign spreads are suffering much less than IG corporate credit and European high yield. Swap spreads, a reliable indicator of interbank tensions, are logically widening. The 2-year swap spread indeed trades over 80 bps. Oil prices plunged, in response to both the risk-off market environment and higher-than-expected Russian production. Brent prices are trading near $72 a barrel. The Japanese yen regains its status as a safe haven, especially as the Swiss franc is penalized by the setbacks of Credit Suisse. Gold is also rising above $1950 an ounce. Cryptocurrencies are rebounding strongly, ignoring the fallout of Signature Bank.

The banking situation is now a central concern over inflation dynamics for market participants and to, a lesser degree, for the central banks. In the euro area, the interest rate policy, which remains guided by inflation risks, is now conditional on financial stability and "data" and will prevail over the analysis of underlying inflation and the transmission of monetary policy according to the ECB’s communiqué on Thursday. In short, financial stability has gone up two notches in the modus operandi of the ECB. This change of heart comes as the ECB raises its growth forecast (1%) and underlying inflation (4.6%) for 2023. Headline inflation is lowered by 1 pp to 5.3% due to the decline in gas prices so far this year. The 2024 and 2025 inflation projections have been sharply reduced (-0.5pp over 2024) and may sound like guidance for lower rates. The ECB no longer pre-commits on its next rate move, probably also take the time to process the reaction of the Federal Reserve. The FOMC is expected to raise the Fed funds rate on Wednesday. That said, the 50 bp hike mentioned after Jerome Powell’s testimony before Congress and the revised PCE inflation numbers now seems less likely. Core inflation remains elevated and the economic situation, given GDP growth of around 2% in the first quarter, does not require any immediate monetary relief. The FOMC's rate projections (the ‘dot plot’) will nevertheless be scrutinized by the market. The financial risks have clearly increased indeed. Use of the Fed's discount window reached $153 billion last Thursday. The new Bank Term Funding Program (BTFP) is used to the tune of $12 billion. This only emphasizes the scale of deposit flight to the larger, better-regulated U.S. banks, on which a rate cut would have no effect. In fact, a group of large US banks now offer a liquidity lifeline to First Republic for $30 billion.

Economic data takes a back seat. However, we are seeing a surprising stabilization of the real estate market with an increase in housing starts and an improvement in developer confidence. Industrial production grew in the first two months of the year. Retail sales are down slightly after their 3.2% rebound in January.

Fixed income markets are experiencing unprecedented volatility. Uncertainty about the trajectory of key policy rates is fueling the nervousness of the Schatz and contributing to the widening of swap spreads. Sovereign risk is preferred to credit even if the flows are mainly dominated by money market funds. Core sovereign debt also outperformed swaps and spread volatility remained low, including on peripheral debt. The widening in credit spreads amounts to 40 bps over one week in the euro area. The 2023 tightening is now history. High yield is 100 bps wider than the previous week’s close. Liquidity conditions have deteriorated in the bond market but IG still trades at wider quotes. The primary bond market came back to a standstill as volatility conditions cooled issuers. On the equity markets, the plunge in European banks reached 13% in the wake of the interest rate rally. Oil companies suffer from the $10 drop in crude prices. Conversely, the Nasdaq and, in its wake, European technology, are benefiting from the relapse in long-term rates.

The market is looking for safe havens. The yen (132) regains this safe haven status, helped in this by the well-established procrastination of the BoJ. The Swiss franc can no longer play this role in the short term for obvious reasons. The euro is stable around $1.06. The dollar no longer attracts flight-to-safety flows and the price of gold indicates renewed interest in the barbaric relic. Somewhat ironically, the upturn cryptocurrency prices also reflect the concern of some stakeholders for banking risk.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	20-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.36%	-33	-54	-40
EUR Bunds 10y	2.13%	-13	-34	-45
EUR Bunds 2s10s	-24.6bp	+20	+20	-4
USD Treasuries 2y	3.96%	-1	-65	-46
USD Treasuries 10y	3.5%	-8	-32	-38
USD Treasuries 2s10s	-47.6bp	-6	+33	+8
GBP Gilt 10y	3.31%	-6	-16	-36
JPY JGB 10y	0.25%	-10	-6	+2
€ Sovereign Spreads (10y)	**20-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	54.76bp	+1	+8	+0
Italy	186.34bp	-6	+4	-27
Spain	107.24bp	-3	+12	-1
Inflation Break-evens (10y)	**20-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.34%	-16	-10	-21
USD 10y Inflation Swap	2.41%	-6	-17	-11
GBP 10y Inflation Swap	3.69%	-14	-7	-23
EUR Credit Indices	**20-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	189bp	+37	+45	+22
EUR Agencies OAS	81bp	+11	+11	+2
EUR Securitized - Covered OAS	94bp	+13	+16	+10
EUR Pan-European High Yield OAS	535bp	+84	+103	+23
EUR/USD CDS Indices 5y	**20-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	99bp	+7	+21	+8
iTraxx Crossover	506bp	+40	+98	+32
CDX IG	88bp	-1	+15	+6
CDX High Yield	520bp	-4	+75	+36
Emerging Markets	**20-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	510bp	+36	+55	+57
Currencies	**20-Mar-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.073	-0.056	0.365	0.2
GBP/USD	$1.228	0.763	1.952	1.6
USD/JPY	JPY 132	1.177	1.967	-0.4
Commodity Futures	**20-Mar-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$72.4	-$8.4	-$11.4	-15.09
Gold	$1 977.4	$63.7	$136.0	8.41
Equity Market Indices	**20-Mar-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 947	2.36	-3.24	2.8
EuroStoxx 50	4 119	0.56	-3.55	8.6
CAC 40	7 013	0.02	-4.40	8.3
Nikkei 225	26 946	-3.19	-1.92	3.3
Shanghai Composite	3 235	-1.03	-2.17	4.7
VIX - Implied Volatility Index	24.36	-8.14	21.68	12.4

Source: Bloomberg, Ostrum AM

Additional notes

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