MyStratWeekly

Market views and strategy

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Topic of the week: Trillions

- **It has been an eventful year for Treasury bond markets, given the debt ceiling issue until May and the subsequent sharp increase in public borrowing as the federal deficit rose to $1.7 trillion this past fiscal year;**
- **The US fiscal outlook has been back in focus this year with a downgrade from Fitch last summer and considerable volatility in the wake of the Fed's monetary tightening;**
- **The US borrowing needs has so far not led to a weaker dollar but global competition for available savings could push yields higher in the coming months;**
- **A dovish Fed and lower than expected increase in bond auctions sizes sparked the recent bond rally, but all eyes will be on the next refinancing announcement once an appropriation bill pass Congress, hopefully in the next few weeks.**

Market review: Warning shot

- **Powell insists Fed will stay vigilant on inflation;**
- **Poor auction of US 30-year bond;**
- **T-note yields hover about 4.60 %;**
- **US Tech powers ahead, extends rally.**

Chart of the week

Source: Bloomberg, Ostrum AM

According to Bloomberg estimates, liquidity in major sovereign debt markets has deteriorated over the past two years. The withdrawal of Central Banks with quantitative tightening and the volatility induced by interest rate increases have contributed to widening the rating ranges.

This liquidity index measures the average yield gap for each security with a residual maturity greater than 1 year compared to an interpolated curve. An increase in the index therefore reflects wider valuation gaps and less liquidity.

Figure of the week

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Source : Bloomberg

$8 a pound of beef in the US, an all-time high due to the drought.

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Topic of the week

Trillions

A trillion here, a trillion there… The US fiscal situation is back in focus. The Fed's ongoing QT and rate hikes have contributed to annual interest expenses topping $1 trillion. The public shortfall reached $1.7 trillion last fiscal year or 7% of GDP. About a third of Treasury coupon securities (excluding bills but including TIPS and FRN) come due within the next 3 years. US debt refinancing will be in focus for some time to come.

An eventful year for US fiscal policy

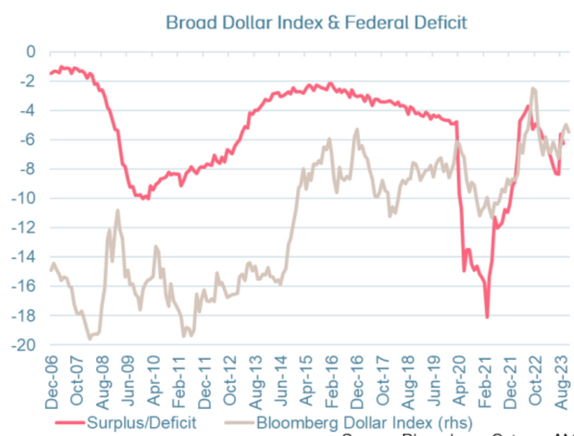
It has been an eventful year for the US federal budget. The debt ceiling was hit in January 2023. When the debt ceiling is reached, the US Treasury cannot raise new debt, so that current federal expenses must be funded by drawing down Treasury cash holdings. At the end of May, there were less than $50 billion in the Treasury general account, government deposits with the Fed. Congress suspended the ceiling after the May quarterly refunding announcement. The US Treasury thus had to rebuild its cash buffer by issuing massive amounts of short-term bills. The bulk of the adjustment in its long-term debt portfolio was indeed postponed to early August. Meanwhile Fitch cut the US debt rating by one notch to AA+ in early August, which added to upward pressure on long-term bond yields. The term premium increased partly because of the challenges to the fiscal outlook.

US fiscal deficit about 7% of GDP

The US economy has fared remarkably well thus far in 2023 compared to the stagnation in the euro area and persistent economic weakness in China. US growth has been above potential (1.8% on Fed estimates) for five consecutive quarters. GDP growth even accelerated to 4.9% at an annualized rate in the three months to September. Economic strength appears partly traceable to fiscal easing.

Tax revenue fell to the tune of $470 billion from a fiscal year ago. Spending is slightly down thanks to cutback in education in August. As a result, the federal deficit increased to $1,695 billion in fiscal year 2023. On the revenue side, the decline in individual taxes by $455 billion over the fiscal year jumps off the page. The 2022 financial market drawdown reduced capital gain taxes. Other revenues were by and large flat except for the $114 billion rise in employment tax. As regards outlays, the increase in Fed rates raised the interest charge considerably. The interest bill is up 184 billion this fiscal year (+39%). Other spending categories recorded sharp rises. Military spending augmented by $54 billion in the 12 months to September 2023. Social security and Medicare expenses increased by a total of $228 billion. Education spending, including payments linked to student debt moratorium, fell sharply towards the end of the fiscal year. The final budget outcome could have been much worse.

In the next chart, it is easy to see that the fiscal situation has a direct impact on the US dollar. The deficit issue is indeed global in scope. A lower dollar could be needed to attract global savings should public borrowing increase further. Governments around the world (e.g. in the euro area) face similar problems so that global competition for funding will only heat up at a time when central banks (Fed, ECB, BoE…) intend to further reduce their bond holdings.



Source: Bloomberg, Ostrum AM

What next: another CR, shutdown or budget passed?

No budget law for fiscal year 2024 has passed Congress yet owing to political infighting within the Republican-led House of Representatives. A stop-gap bill or continuing resolution was passed instead. Continuing resolutions are temporary spending bills that allow federal government operations to continue when final appropriations have not been approved by Congress and the President. Without final appropriations or a continuing resolution (CR), there could be a lapse in funding that results in a government shutdown. The current CR runs until November 17. Beyond this deadline, there could be a shutdown, another CR or an appropriation bill.

The quartely refinancing announcement in focus

The US Treasury announces its refunding strategy on a quarterly basis. Each February, May, August and November, the Treasury department announces auction sizes for coupon securities with maturities from 2 years to 30 years. The high credit quality of the US and the benchmark status of Treasury bonds allow the US government to borrow cheaply and pay reduced liquidity premia across the maturity spectrum. That said, the market is not insensitive to auction sizes and the maturity choices of the Treasury. The return to net bond issuance in August after the suspension of the debt ceiling sparked a sharp increase in long-term yields. Fed Governor Christopher Waller even described the 100 bp upshot as an earthquake… to which the Fed contributed by allowing bond holdings to mature to the tune of $ 60 billion a month. Indeed the Fed's quantitative tightening amounts to $720 billion a year of additional refinancing need for the Treasury.

The latest announcement in early November was welcomed by markets as it coincided with a more dovish Fed stance and month-end duration-extension buying from benchmark fund managers. The key message here was the modest uptick in the auction sizes for 7-, 10- and 30-year bonds and no increase in the unpopular 20-year bond. The bulk of the dollar-amount increase in debt financing will be on 2- to 5-year coupons and, to a lesser degree, 3-year coupons and 2-year FRNs.

US Treasury Bond Auction Sizes ($ billion)

Coupon security Maturities	2-year	3-year	5-year	7-year	10-year	20-year	30-year	FRN
August	45	42	46	36	38	16	23	24
September	48	44	49	37	35	13	20	24
October	51	46	52	38	35	13	20	26
November	54	48	55	39	40	16	24	26
December	57	50	58	40	37	13	21	26
january	60	52	61	41	37	13	21	28

Source: US Treasury Dept, Ostrum AM

The Treasury monthly auction schedule starts with the sales of the new 3-, 10- and 30-year benchmark bonds. So far, the 3-year bond auction drew good demand from market participants with modest tail compared to grey market prices. The acid test for the Treasury market will come later this month with 2s and 5s increasing by $ 9 billion compared with the August transaction. The 5-year bond tends to dictate market direction so that poor auction results could unwind the recent rally.

There is another source of uncertainty. The appropriation bill could pass Congress around November 17, ahead of the 2s, 5s and 7s auctions. By then, the expected borrowing requirement will feed into expectations for the February quarterly refinancing announcement. If the budget shortfall is expected to narrow thanks to higher expected revenue (individual taxes for instance), lower bond yields may stick. On the contrary, if federal government maintains high deficit spending, a new bond rout could be in the making.

Conclusion

Fiscal policy has supported US growth in 2023 but high federal debt, a rating downgrade and the Treasury refinancing strategy has sent yields much higher from August to October. The November quarterly refinancing, a dovish Fed stance and the lack of a budget bill sparked a sharp rally in bonds… but it is unclear whether low yields can stick in the context of high public borrowing and continued quantitative tightening.

Axel Botte

Market review

Warning shot

The ping-pong continues between the Fed and the markets which want to believe in monetary easing.

The reaction of financial markets to the status quo on US rates probably went beyond the Fed's intentions. Jerome Powell therefore took advantage of his speech at the IMF meeting to reaffirm the need to act in the event of a further rise in inflation. The sharp drop in US Treasury yields gave way to profit-taking last week, bringing the T-note back to around 4.60%. The sensitivity of stocks to long-term rates was evident in the sharp drop in equity market indices following the poor results of the US 30-year bond auction on Thursday. The Bund yield stood at 2.70% at the end of the week after Christine Lagarde called for unchanged ECB rates through the first half of 2024. Inflation expectations are falling in keeping with the $4 weekly drop in crude oil prices. At the same time, sovereign spreads are tightening with the exception of Portuguese bonds following the resignation of Prime Minister Costa. Swap spreads continue their narrowing trend, leading to strong performance in credit and debt linked to the swap rate. The dollar was stable at high levels while the Japanese yen resumed its downward spiral. Equity markets appear to be consolidating after a sharp rebound since the start of the month.

The US data calendar was light last week. The economic situation remains favorable in the United States. The higher-than-expected trade deficit should, however, lead to a marginal revision of US growth in the 3rd quarter. Initial jobless claims remain at a low level. In the euro area, the ECB consumer expectations survey showed an increase in household inflation expectations in September at 4% on a 1-year horizon. The short-lived increase in oil prices two months ago likely explains this rebound. In China, deflation is reemerging (-0.2% on the October CPI).

The poor auction of US 30-year Treasury bonds ultimately seems an epiphenomenon given the resumption of curve flattening thereafter. However, it is symptomatic of the extent of refinancing risks in the United States, which will remain significant throughout the next year. The rebuilding of the term premium appears incomplete despite current high volatility. The T-note yield hovers around 4.60%. Forward breakeven inflation rates (5 years in 5 years) have deteriorated recently, echoing the rise in US household price expectations (4.2% at 1 year). In the euro area, Christine Lagarde echoed Jerome Powell and reiterated the need to keep rates high. The Bund yield rose back to around 2.70%. An extension of the rebound in euro bond yields could be taking shape as the 3% target looms large. Sovereign spreads performed well with issuance successes in Italy and Austria. The resignation of PM Costa in Portugal led to profit taking on PGBs. Early elections are now scheduled for next March. Portuguese sovereign credit remains strong so that debt should continue to converge towards 100% of GDP in 2024. Greek bond spreads are also approaching recent lows. The narrowing in sovereign spreads may however look overdone excessive, particularly in Italy (187 bp). As concerns emerging sovereign debt, spreads narrowed by 10 bp with a few new issues (Costa Rica, Colombia) fueling demand.

The European credit market is benefiting from the tightening in swap spreads. In turn, iTraxx indices outperform cash corporate bonds. Primary market activity totaled around €15 billion last week, evenly split between financial and non-financial issuers. Concerns about US commercial real estate are having an impact on the Pfandbrief sector in Germany, but euro area real estate companies have proven resilient. Hybrid debt and subordinated insurance bonds performed well. In parallel, the euro high yield market remains upbeat. The average European high yield spread stands at 468 bp against Bunds, down 5 bp last week. The extent of the tightening in iTraxx Crossover spreads (412 bp) over the past month nevertheless calls for caution. Protection buying is warranted in the current environment. The AT1 group, which is coming to life with the first UBS issue since the takeover of Crédit Suisse, still offers an appreciable discount compared to the spreads on B-rated bonds.

Stocks end the week trading sideways. The FANG group nevertheless gained 3% while US small-cap stocks fell by almost 4%. In Europe, the market is up slightly thanks to growth and quality stocks.

Axel Botte

Main market indicators

G4 Government Bonds	13-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.08%	+5	-6	+31
EUR Bunds 10y	2.7%	-4	-4	+13
EUR Bunds 2s10s	-37.7bp	-9	+3	-17
USD Treasuries 2y	5.05%	+12	+0	+63
USD Treasuries 10y	4.63%	-1	+2	+76
USD Treasuries 2s10s	-42.4bp	-13	+2	+13
GBP Gilt 10y	4.31%	-7	-8	+64
JPY JGB 10y	0.87%	-1	-3	-19
€ Sovereign Spreads (10y)	13-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
France	57bp	-3	-5	+3
Italy	183bp	-8	-9	-31
Spain	104bp	-2	-3	-4
Inflation Break-evens (10y)	13-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
EUR 10y Inflation Swap	2.38%	-2	-11	-17
USD 10y Inflation Swap	2.57%	-7	-2	+4
GBP 10y Inflation Swap	3.82%	-1	-6	-9
EUR Credit Indices	13-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Corporate Credit OAS	153bp	-2	-10	-14
EUR Agencies OAS	73bp	-3	-8	-6
EUR Securitized - Covered OAS	78bp	-3	-11	-5
EUR Pan-European High Yield OAS	466bp	-8	-13	-46
EUR/USD CDS Indices 5y	13-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
iTraxx IG	75bp	-3	-9	-16
iTraxx Crossover	407bp	-11	-34	-67
CDX IG	68bp	-3	-8	-14
CDX High Yield	436bp	-33	-59	-48
Emerging Markets	13-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
JPM EMBI Global Div. Spread	431bp	+7	-20	-22
Currencies	13-Nov-23	1wk (%)	1m (%)	2023 (%)
EUR/USD	$1.069	-0.280	1.694	-0.2
GBP/USD	$1.225	-0.770	0.873	1.4
USD/JPY	JPY 152	-1.107	-1.437	-13.6
Commodity Futures	13-Nov-23	-1wk ($)	-1m ($)	2023 (%)
Crude Brent	$81.6	-$3.6	-$7.8	0.5
Gold	$1 937.7	-$40.5	$4.9	6.2
Equity Market Indices	13-Nov-23	-1wk (%)	-1m (%)	2023 (%)
S&P 500	4 415	1.31	2.02	15.0
EuroStoxx 50	4 221	1.49	2.04	11.3
CAC 40	7 074	0.86	1.00	9.3
Nikkei 225	32 585	-0.38	0.83	24.9
Shanghai Composite	3 047	-0.39	-1.35	-1.4
VIX - Implied Volatility Index	15.07	1.21	-22.00	-30.5

Source: Bloomberg, Ostrum AM

Additional notes

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