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Market views and strategy

Ostrum ASSET MANAGEMENT

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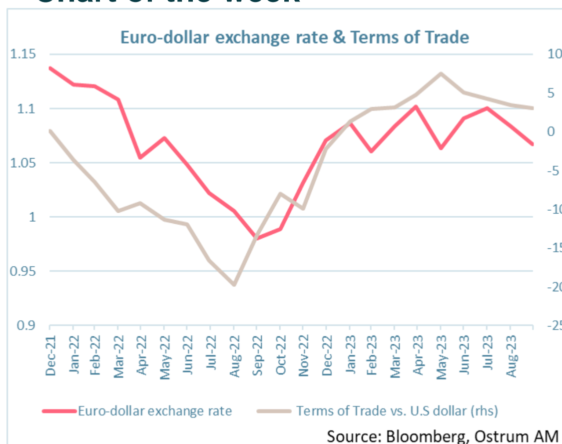
Topic of the week: ECB: one last hike

- **The ECB raised its rates by 25 bps due to inflation expected to remain "too high for too long";**
- **The important point comes from the change in communication suggesting that this increase is probably the last;**
- **The ECB should opt for an extended status quo until mid-2024;**
- **At the same time, monetary policy will become more restrictive through the end of reinvestments of reimbursement under the APP and TLTRO reimbursements;**
- **The objective is to firmly anchor inflation expectations.**

Market review: The ECB had no choice

- **ECB raises deposit rates to 4%;**
- **ECB cuts growth forecasts amid sticky inflation;**
- **The Fed may tighten policy further;**
- **Higher yields having little impact on risky assets.**

Chart of the week



The euro depreciated towards $1.06 despite the ECB's 25 bp rate hike. The weakness of economic surveys in the eurozone and the significant growth gap with the United States are contributing to the decline of the single currency.

In addition, the rebound in oil, and more generally in imported raw materials, is deteriorating the eurozone's terms of trade. In 2022, the surge in gas had reduced the euro below parity.

Figure of the week

32

Source : Bloomberg

Spending from climate-related events has accounted for 32% of US GDP growth since 2016, according to Bloomberg intelligence.

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●Topic of the week

ECB: One last hike

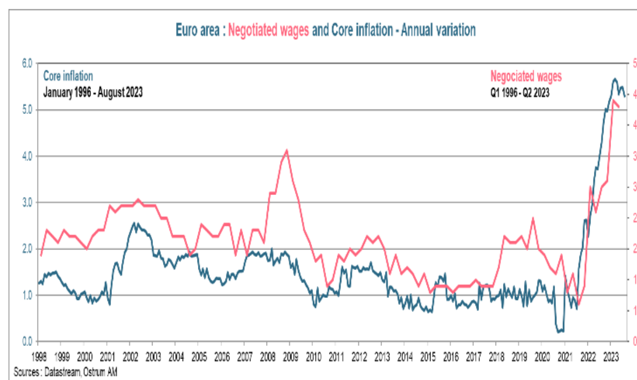
Despite weaker growth than expected, the ECB raised its rates by 25 basis points due to inflation expected to remain "too high for too long a period". The important point lies in the change in communication on the expected evolution of key rates. The ECB suggests that this is probably the last rate hike, which paves the way for a prolonged status quo to anchor inflation expectations.

Inflation too high

According to preliminary figures, inflation in the Eurozone stood at 5.3% in August. It has slowed significantly compared to the peak of 10.6% recorded in October 2022 but it remains well above the 2% target followed by the ECB. This moderation is essentially linked to a significant base effect on energy prices which is reflected in the now negative contribution of the latter. Food prices have moderated slightly to remain high.

Wage tensions

Core inflation (which excludes volatile components like energy and food) is slowing down only very slowly. It went from a high of 5.7% in March 2023 to 5.3% in September. This mainly results from the strong contribution of service prices (at historic highs). This reflects the spread of past increases in energy prices to a larger number of sectors as well as wage pressures.



Sources : Datastream, Ostrum AM

Faced with labor shortages and high inflation, business leaders have increased wages. In the 2nd quarter, these increased at a still very high rate: 4.3% for negotiated salaries, after 4.4% in Q1. They will take a little longer to adjust to the slowdown in inflation, particularly given the process of integrating the latest wage negotiations. The contribution of the price of goods has moderated.

Upside risk with energy prices

In addition, risks to inflation have increased recently with renewed tensions over energy prices and the return of the price of oil above $90 per barrel. This is a factor which has particularly weighed on the latest surveys carried out among households and businesses.

The ECB's inflation outlook has thus been revised upwards in 2023 and 2024 mainly due to energy prices. The underlying inflation outlook has been revised slightly lower due to expectations of lower growth. They still remain above the target of 2% in 2025 (2.2% on average).

Inflation forecast of the ECB

	2023	2024	2025
	Headline Inflation		
September	5.6	3.2	2.1
June	5.4	3	2.2
	Core inflation		
September	5.1	2.9	2.2
June	5.1	3	2.3

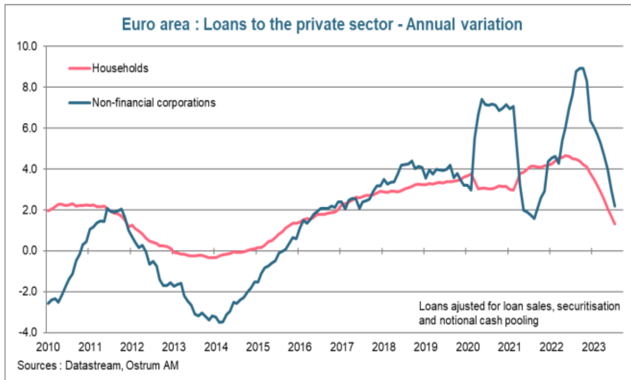
Sources : ECB, Ostum AM

It should be noted that the ECB's inflation forecasts are based on certain technical assumptions concerning commodity prices, interest rates and the euro. These take into account market data which was finalized as of August 22. They therefore do not include the sharp rise in oil futures prices (of nearly $10).

Strong transmission of monetary tightening

Between July 2022 and July 2023, the ECB raised its rates by 425 basis points to bring the deposit rate to 3.75%. This is a monetary tightening of unprecedented scale and speed. It was spread to financial conditions and more quickly than normal, according to Christine Lagarde.

The average rate on real estate loans granted to households thus increased sharply to reach 3.75% in July, compared to 1.3% in January 2022, and the average rate on business loans peaked at 4.9% in July, compared to 1.8% in June 2022. This resulted in a clear slowdown in the annual growth of loan demand. Loans for households increased over one year by 1.3% in July 2023 compared to 4.6% in June 2022. Those granted to businesses slowed down further: 2.2% compared to 8.9% in October 2022. Monetary tightening is reverberating with a certain delay on the economy and its effects will persist over the coming months.



Low growth

Unsurprisingly, the ECB has revised its growth outlook downwards. It included the revision of GDP for the 2nd quarter in the Eurozone, to 0.1%, compared to 0.3% as initially published, and the deterioration of economic surveys during the summer. They reveal a spread of weakness from the manufacturing sector to the services sector, while the latter remained well oriented until now. This is happening while the unemployment rate is at a historic low (6.4% in July) and wages are still growing rapidly. Job creation is nevertheless starting to moderate and surveys indicate a further slowdown to come.

Growth forecast of the ECB

	2023	2024	2025
Septembre	0.7	1	1.5
Juin	0.9	1.5	1.6

Sources : ECB, Ostum AM

The reasons for this lower expected growth lie in the continued high inflation, which weighs on purchasing power, the lack of impetus from foreign trade (with the disappointing growth of China in particular) as well as the increasingly significant impact of the monetary tightening carried out by the ECB.

ECB decisions

A final rate hike of 25 bp

The ECB decided to raise its rates by 25 basis points by a “solid majority of governors” due to inflation expected to remain too high, for too long. The deposit rate was thus raised to 4%, a historic high, totaling 450 basis points of increase since July 2022. The important point is the change in communication on the evolution of rates. A sentence was added to the press release issued after the meeting: *“Based on its current assessment, the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target. The Governing Council’s future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary.”.*

The ECB therefore suggests that this rate hike is probably the last and that it will maintain the status quo long enough to allow inflation to return to the 2% target in the medium term. The central bank of course left the door open to a possible further rate hike if necessary, depending on the data.

Nothing has changed on the PEPP and the APP

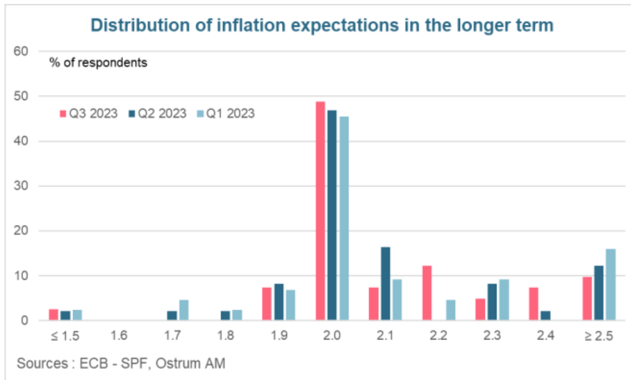
The ECB reiterated the fact that reinvestments of repayments of maturing securities under the PEPP would continue at least until the end of 2024. To a question from a journalist on a potential cessation of reinvestments before the end of 2024, C. Lagarde replied that this had not been discussed. She also insisted on the fact that the PEPP was the first line of defense to ensure the transmission of monetary policy to all countries in the event of unjustified tensions on certain spreads. In this case, it can indeed use the flexibility offered by this program by occasionally favoring certain obligations over others.

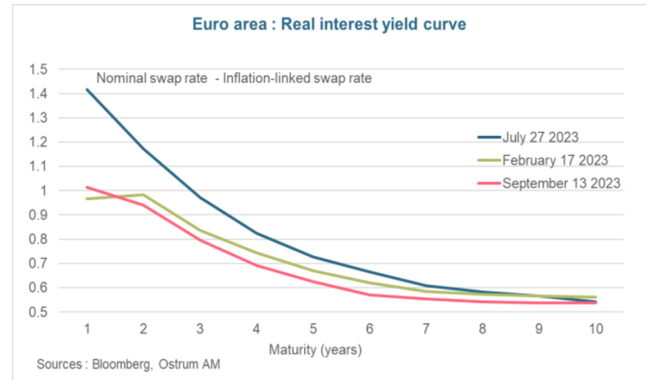
The ECB's balance sheet also continues to contract with the cessation of reinvestments of payments under the APP since July and repayments of TLTROs (targeted long-term operations). The size of the ECB's balance sheet decreased from 8,770 billion euros in mid-November 2022 to 7,200 billion euros.

Need to firmly anchor inflation expectations

The ECB's decision was motivated by the need to firmly anchor inflation expectations given that it remains high and is proving more persistent than expected. However, these expectations have tended to strengthen recently. The ECB household survey revealed a slight increase in median 3-year inflation expectations in July: to 2.4%, compared to 2.3% in June. Average 3-year inflation expectations also increased to 3.9% from 3.8%.

In the Survey of Professional Forecasters, long-term inflation expectations (5 years) remain well anchored at 2.1% in Q3. However, the distribution has changed: the proportion of those expecting inflation below 2% has fallen significantly (from 16% to 10% between Q1 and Q3) and the proportion of those anticipating inflation above 2% has increased, to remain high, going from 39% to 41%, well above the average which prevailed between Q3 2003 and Q4 2019. The share of those anticipating inflation greater than or equal to 2.5% remains significant (10%). The ECB is monitoring these developments carefully.





Long-term inflation expectations contained in the markets have also deteriorated. This particularly weighed on inflation swap rates. The result is that real interest rates, measured by nominal swap rates minus inflation swap rates, fell over the different maturities between the ECB meeting of July 27 and September 13. The real rate curve has thus returned to the levels which prevailed in mid-February while the ECB had in the meantime raised its rates by 125 bp. This drop in real interest rates goes against the monetary tightening of the ECB, which motivated this latest increase in rates and their maintenance at a high level for a sufficiently long time.

Conclusion

By raising its rates by 25 basis points in September, the ECB wanted to strengthen the effect of its restrictive monetary policy in order to firmly anchor inflation expectations. It is expected to leave its rates unchanged until mid-2024. Monetary policy will become more restrictive by then due to the end of reinvestments of payments under the APP (nearly 300 billion euros by mid-2024) and TLTRO repayments (nearly €460 bn). This should allow the ECB to continue reinvestments under the PEPP until the end of 2024 in order to maintain a certain flexibility in the event of unjustified tensions on the spreads of peripheral countries.

Aline Goupil-Raguénès

Market review

The ECB had no choice

The ECB forced to act amid sticky inflation as the rise in oil prices further threatens price stability. The better economic situation in the United States argues for a further increase.

The persistence of high inflation despite signs of a cyclical downturn is the worst economic backdrop for the ECB. The 25 bp rate increase, although probably the last hike of the ECB's monetary cycle, does not mean the end of monetary tightening. Balance sheet amortization takes over from interest rate policy. Bond yields are trending towards 2.65% on the 10-year German Bund, partly reflecting fears of inflation fueled by the recent rise in the price of oil. The supply shortfall on the oil market is estimated at between 2 and 3 million barrels per day. A sudden rise in crude oil above $100 per barrel would undoubtedly revive fears of stagflation. At this juncture, risky assets remain well oriented. The monetary status quo indeed provides visibility on 'carry' assets. Equity volatility also remains low and stable. Credit is tightening in the wake of swap spreads and the major equity markets bounced back by 1 to 3% over a week. The strength of the dollar has no impact on raw material prices, which benefit from improving economic data out of China. The Australian and New Zealand dollars traded higher on stronger Chinese growth. In turn, spreads on emerging debt in U.S. dollars (418 bps) are remarkably stable.

The ECB raised its interest rates by 25 bp bringing the deposit rate to 4%. A status quo on policy rates should now prevail until mid-2024. Monetary tightening nevertheless continues via balance sheet contraction. The absence of an announcement on the PEPP highlights the ECB's cautious approach. A commitment to reduce PEPP reinvestments would further reduce the possibility of monetary relief at a time when the growth prospects looking out to 2025 has been revised downwards. The forecast for 2024 GDP growth was cut to 1% (-0.5 pp compared to the June forecasts). ECB forecasters penciled in a gradual return to potential output growth thereafter (1.5% in 2025). Inflation will decrease but the projections for 2023 and 2024 were revised upwards. It should be noted that these inflation projections are finalized on August 22, thus before the upward acceleration of oil prices beyond $90 and the fall of the euro near $1.06. In addition, euro area wage increases remain upbeat at 5% in 2Q 2023 in the Eurozone. From our point of view, the Fed will make a similar analysis to that of the ECB regarding risks to price stability. The Fed could choose to ignore high oil prices, but household inflation expectations may be affected. Social conflicts, such as the strike in the automobile sector, may fuel wage demands elsewhere. On the other hand, the rebound in real estate, a sector highly sensitive to monetary policy decisions, should be monitored closely by policymakers FOMC. Producer prices rebounded in August. Fed projections for year-over-year growth in 4Q 2023 will be revised upwards thanks to consumer spending. August retail sales indeed increased by 0.6%, confirming the pickup in consumer expenditure reported in July. In sum GDP growth is expected to be around 3% in the third quarter.

Markets were late to price in the ECB's interest rate hike, with participants no doubt hoping that the mediocre surveys would prevent central bankers from acting. The German 2-year rose again to around 3.20% at the end of the week. The 10-year is tending towards 2.65%, or around 10 bps below the March highs reached before the SVB bankruptcy despite a deluge of bond issuance from sovereign and supranational issuers. The lack of guidance on the PEPP allowed a knee-jerk narrowing in sovereign spreads, which will subsequently reversed to a degree. Overall, questions about Italian (with likely revisions in the 2023 deficit towards 6%) and French public finances (as Bruno Le Maire announces savings of €16 billion) still pose a risk of wider sovereign spreads in 4Q 2023. The increase in inflation breakeven rates explains half of the rise in long-term bond yields. The ECB's action may revive expectations for a Fed hike this week. We therefore anticipate a final move of 25 bp this Wednesday. The pattern of pause in June then increase in July could nevertheless be repeated. In this case, the next rate hike would occur in November. The US 2-year yield is back above the 5% threshold and the 10-year note yield is trading about 4.30%. The refinancing activity of the US Treasury will continue to weigh on long-term rates, especially as foreign demand is reduced.

The credit market is resisting the weight of new corporate bond issues and the anticipated weakening of the European economic cycle. The market exhibits a moderate risk of spread widening over the months to come. However, investment grade credit fund inflows continue. In European high yield, net fund outflows have been recorded for the past two months even as valuations which continue to richen. The spread decompression trend remains despite a cautious consensus regarding the single-B ratings and lower. The B-BB premium remains near multi-year tights.

As regards the foreign exchange market, the greenback remains solid. The PBoC's monetary stimulus action and some reassuring data provide support to the Chinese yuan.

On stocks, Europe continues to trade within a narrow channel of 200 points on the Euro Stoxx 50. Banks and insurance stock perform well on higher rates. Cyclicals and oil outperformed while European technology lost 2%, even as the US Nasdaq gained.

Axel Botte

Main market indicators

G4 Government Bonds	18-Sep-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.26%	+16	+20	+49
EUR Bunds 10y	2.71%	+7	+9	+14
EUR Bunds 2s10s	-54.9bp	-9	-11	-34
USD Treasuries 2y	5.06%	+7	+11	+63
USD Treasuries 10y	4.34%	+5	+8	+46
USD Treasuries 2s10s	-72bp	-1	-3	-16
GBP Gilt 10y	4.41%	-6	-27	+74
JPY JGB 10y	0.72%	+1	+11	-17
€ Sovereign Spreads (10y)	**18-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	55bp	+1	+3	+0
Italy	181bp	+5	+15	-33
Spain	107bp	+2	+6	-1
Inflation Break-evens (10y)	**18-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.67%	+3	+5	+12
USD 10y Inflation Swap	2.65%	+2	+5	+12
GBP 10y Inflation Swap	3.99%	+0	+13	+8
EUR Credit Indices	**18-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	148bp	-7	-2	-19
EUR Agencies OAS	73bp	-1	-2	-6
EUR Securitized - Covered OAS	80bp	-2	-6	-4
EUR Pan-European High Yield OAS	428bp	-20	-11	-84
EUR/USD CDS Indices 5y	**18-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	70bp	0	-8	-21
iTraxx Crossover	390bp	-5	-39	-83
CDX IG	63bp	0	-8	-19
CDX High Yield	425bp	-1	-30	-59
Emerging Markets	**18-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	416bp	-4	-2	-36
Currencies	**18-Sep-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.067	-0.772	-1.895	-0.4
GBP/USD	$1.239	-0.975	-2.725	2.5
USD/JPY	JPY 148	-0.785	-1.597	-11.3
Commodity Futures	**18-Sep-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$94.8	$4.1	$10.4	15.4
Gold	$1 924.5	$2.2	$35.2	5.5
Equity Market Indices	**18-Sep-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 450	-0.83	1.84	15.9
EuroStoxx 50	4 251	-0.07	0.91	12.1
CAC 40	7 272	-0.09	1.51	12.3
Nikkei 225	33 533	2.84	6.62	28.5
Shanghai Composite	3 126	-0.54	-0.19	1.2
VIX - Implied Volatility Index	14.60	5.80	-15.61	-32.6

Source: Bloomberg, Ostrum AM

Additional notes

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