MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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Axel Botte
Head of Market Strategy
axel.botte@ostrum.com

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

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

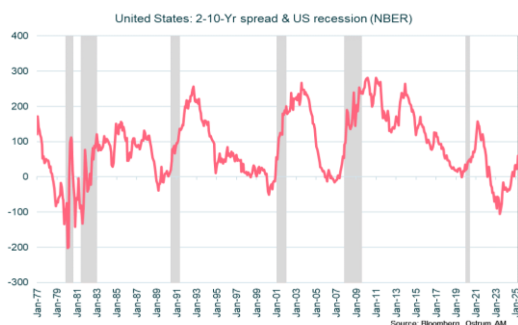
Topic of the week: The risk of a "Donald Truss" moment
by Axel Botte

- The global economy has long been driven by U.S. domestic demand. The U.S. administration claims it wants to reduce America's external imbalances by imposing prohibitive tariffs. Europe and China are also taking measures to stimulate their domestic demand. China does not intend to negotiate;
- Trump's advisors believe that the dollar's status as a reserve currency has become a burden, resulting in an overvaluation of the dollar. Steven Miran aims to make the rest of the world pay for the security and reliability provided by the U.S. currency;
- The U.S. government is reportedly seeking to force foreign creditors to accept a restructuring of U.S. debt converted into a 100-year loan. This is the purpose of the Mar-a-Lago accord mentioned by Steven Miran. The resulting decline of the dollar would also serve as a means to correct the trade balance;
- However, the U.S. economy is very sensitive to financial markets. Tampering with the credibility of the United States and its credit risk is extremely dangerous. Markets have understood this well, and a significant credit risk premium is now embedded in U.S. long-term rates;
- The risk of debt restructuring, and a sharp depreciation of the dollar raises the specter of a collapse in the Treasury market, reminiscent of the British episode during the brief government of Liz Truss.

Market review: On hold
by Axel Botte

- The 90-day tariff pause triggers a historic rebound in U.S. indices;
- However, escalation continues with China;
- Rates: the 10-year T-note experiences its worst week since 1982 (+55 bps), with the Bund acting as a safe haven;
- Massive outflows from high yield and leveraged loan mutual funds.

Chart of the week



The term structure of interest rates is a time-tested indicator of economic conditions. An inversion in the 2-10-Yr yield spread often foreshadows downturn. Conversely, as the economic enters recessions, market participants anticipate rate cuts from the Fed which results in steepening.

In extreme market conditions, investors may sell long-dated bonds to cover for losses elsewhere and park cash in shorter-dated bills.

The sharp yield curve steepening must thus be monitored closely.

Figure of the week

-9.5

This is the percentage decline in the broad DXY dollar index from its January 13 high. The dollar has fallen to 3-year lows.
Source: Bloomberg

Topic of the week

The risk of a Donald Truss moment

The U.S. administration is imposing tariffs on all foreign countries. The protectionist measures are an attempt to make the world pay for security and ease to do business worldwide enabled by the U.S. dollar and military. The tariffs have rattled financial markets including the supposedly safe Treasury bond market, which failed to shelter investors from equity market losses. High public deficits and a self-inflicted crisis may set the stage for a Liz Truss moment for Treasuries.

The challenges posed by U.S. tariffs in a lopsided world economy

Sweeping tariffs means headwinds for supply chains, corporate profits

Following President Trump's sweeping tariffs, global companies and investors will face significant near-term challenges. The global economy will be walking a fine line as recession odds rise everywhere. Corporate profit growth and supply-chain stability will face headwinds reminiscent of the Covid period. The NFIB survey for March confirms earnings pressure and dwindling confidence in the economic outlook. The ability to adapt to changing circumstances, linked to the geopolitical backdrop, the military situation and trade relationships, will be key for global companies.

The U.S.-imposed tariffs have jolted the U.S.-European economic relations. There is a greater sense that Europe might become more coordinated in response to U.S. trade actions. Still national interests could prevent EU member countries from striking an optimal response to the unprovoked trade war started by President Trump. China chose to retaliate forcefully, imposing its own reciprocal tariffs and limitations to both imports and exports. Escalation to de-escalate may not work this time around.

For decades, the U.S. consumer has been the dominant source of demand for the world economy. American households consume about 20% of world output. The U.S. claims that incurred imbalances have grown to unsustainable levels. Demand will have to come from other countries. With U.S. commitments to the security of allied countries now on the line, defense spending in Europe will have to rise. The EU defense plan is worth 800 billion euros, half of it coming from Germany. Germany will thus reduce its trade surplus by running larger fiscal deficits. Infrastructure spending will chip in another 500 billion euros. China's economic growth model must also be rebalanced away from real estate and cost-competitive exports towards high value-added exports and consumer spending. Much of that rebalancing is already underway but private consumption remains missing. The Chinese government has put forward a series of measures to spur household spending, but it may take years and social security reforms to cut into precautionary savings.

The role and legitimacy of the U.S. dollar

The reserve currency status of the U.S. dollar is now seen as a disadvantage

Being able to issue the world's reserve currency is a privilege for the U.S., a unique "exorbitant" privilege that reflects economic and military superiority. Yet, the current administration seems to downplay the advantage and see the dollar anchor as a problem. Steven Miran openly calls for the U.S. to be compensated by the rest of the world for the benefit to use dollars to settle

global trade. In Trump's economic advisor's own words: "two foreign nations, say China and Brazil, trading with each other. Neither country has a currency that is trusted, liquid, and convertible, which makes trading with each other challenging. However, because they can transact in U.S. dollars backed by U.S. Treasuries, they are able to trade freely with each other and prosper. Such trade can only occur because of U.S. military might ensuring our financial stability and the credibility of our borrowing." [1]

The quote from Steven Miran's is quite telling of the resentment of the current U.S. government towards foreign countries. It obviously fails to recognize that 'dark matter' linked to the reserve currency status has allowed the Unites States to borrow from the rest of the world continuously in its own currency for 40 years. And that's a huge advantage. U.S. companies do not have to manage foreign exchange fluctuations and have access dollar financing from a global investor base. This is indeed the so-called dark matter enabling the U.S. to grow out of external imbalances.

China's capital controls still limits the role of the yuan as a global currency

The issue is being sorted out - so to speak - as a growing share of global trade is denominated in Chinese Renminbi. Saudi Arabia sells oil to China in Renminbi. Furthermore, China's loans to Asian and African nations for infrastructure investment have made the yuan more international since the Great Financial Crisis. Nevertheless, China's capital account remains quite close. Chinese authorities keep tight controls on capital flows. The Chinese yuan exchange rate is managed by the PBoC.

On the U.S. side, talks of a strategic reserve in cryptocurrencies could further undermine the legitimacy of the greenback as the world's reserve currency. The purchases of Bitcoin and possibly other cryptocurrencies would be equivalent to a debasement of the dollar.

Playing with the full faith and credit is dangerous

Full faith of credit in jeopardy?

The U.S. administration is getting creative to make the world pay. The Mar-a-Lago accord floated by Steven Miran would coerce the rest of the world into a debt exchange of their U.S. Treasury bond holdings for 100-year or perpetual bonds to pay for the security and ability to trade offered by the U.S. Let's be clear about one thing: this is equivalent to a default and the end of full faith and credit of the United States. Furthermore, just over 23 % of Treasury debt is held by foreign and international investors. Indeed, the U.S. has a very developed financial system and the Federal Reserve still holds $4.2 trillion Treasuries even after 2 years of quantitative tightening. Even if a debt exchange goes through, mutual funds holdings say 2-year paper would receive bonds out of line with their preferred investment habitat and would have to sell. A Mar-a-Lago accord to restructure the debt and weaken the dollar thus looks impractical.

Furthermore, there could not be a worse timing for a coercive debt deal. The debt ceiling is in effect since January. The U.S. government cannot borrow to finance a growing deficit whilst the current economic turmoil could bring forward the risk of a technical default. The X-date is anywhere between late May and August depending on the monthly budget execution. The government always turns a sizeable surplus in April, but the IRS tax intake forecasts are being revised lower. Medicare payments and other expenses loom large in May-June.

[1] https://www.whitehouse.gov/briefings-statements/2025/04/cea-chairman-steve-miran-hudson-institute-event-remarks/

Can the U.S. Treasury market seize up?

Liz Truss moment looks possible in US bond space

The U.S. Treasury should not take the current market turmoil lightly. The Liz Truss moment in the fall of 2022 in the UK forced the BoE to intervene to stave off an acute liquidity crunch at pension funds. Unfunded tax cuts, poor communication of government officials spark a bout of volatility that shook the financial system. Government bonds have not performed their safe haven roles as equity markets took a nosedive in April for a reason. A rapid steepening in the yield curve is often an indication of an economic downturn or a recession. It is also a reflection of growing concern about federal debt sustainability. The highest credit quality (AAA) of the United States underpins the dollar-centric financial world. The inflation-adjusted yield on 30-Yr Treasury bonds is up to 2.70 % significantly above potential output growth. This is because real yields embed the sovereign credit premium.

Another measure of that credit premium is the swap spread or the difference between OIS and Treasury yields for a given maturity. The gap hit -62 bps on 10-Yr maturities and even -100 bps on 30-Yr maturities last week. This must cause concern at the U.S. Treasury Department. Last week's auctions of 3-, 10- and 30-Yr bonds went okay on balance after market prices adjusted lower. At bond auctions, primary dealers are required to bid to ensure that the transaction is a success.

In that regard, the swap spread can also be interpreted as balance sheet space for market intermediaries using repo financing. The more negative the swap spread the smaller the primary dealers' ability to hold bonds. On New York Fed data, dealers' balance sheets look quite stretched after holdings of Treasuries rose to 387 billion total in late March. Holdings are up nearly 100 billion from a year ago. Primary dealers have had to absorb outflows from mutual funds and sales from foreign investors including the PBoC. To stem selling pressure on the yuan, the PBoC must sell dollars as the CNY nears its lower bound. To do this, it offloads US. Treasury securities. This is not a new phenomenon, PBoC holdings have shrunk from $1.2 trillion in 2021 to just $700 billion at present, but it appears that bond sales have accelerated recently.

The other financial plumbing issue lies with basis trades implemented by hedge funds. By exploiting small pricing differences, these market participants bring liquidity to cash and futures markets, using repo financing. These trades link all the markets together. Basis trades have grown considerably, and the BIS and the IMF have pointed the risk that disorderly unwinds might cause market disruption.

Conclusion

The U.S. Treasury bond market is under stress at present. The federal deficit continues to rise from already unsustainable levels as uncertainty related to Trump's tariff war takes markets by storm. Whilst moving the deep U.S. Treasury market takes a lot of effort, a disruptive Liz Truss moment is no longer unimaginable.

Axel Botte

Market review

On Hold

The announcement of a 90-day pause on tariffs above 10% offers some respite to equity markets, but the escalation of measures between China and the United States continues. Concerns are mounting over long-term U.S. rates, with the 30-year yield exceeding 4.90%. Gold is rebounding as the dollar declines.

The announcement of a 90-day pause on tariffs above 10% offers some respite to equity markets, but the escalation of measures between China and the United States continues. Concerns are mounting over long-term rates, with the 30-year yield exceeding 4.90%. Gold is rebounding as the dollar declines.

The historic rebound in stocks following the announcement of the pause (+9.52% on Wednesday for the S&P 500) barely conceals the discomfort in the bond markets. The 30-year bond is experiencing its worst week since 1987, with an increase of over 40 bps. The sharp tightening of swap spreads reflects both stress on bank balance sheets and the sovereign credit premium now embedded in U.S. long-term rates. At the same time, outflows from risky assets (high yield, leveraged loans) are at unprecedented levels since COVID. The decline of the dollar is the ultimate sign of capital flight. In this complex context, the Fed does not want to appear as Donald Trump’s savior amid his detrimental economic policies and international relations. China, which does not benefit from the tariff relief granted to the rest of the world, is engaging in an escalation aimed ultimately at isolating the United States. It should be noted that the 10% tariff pause, combined with a 145% increase in tariffs on Chinese goods, raises the average tariff burden compared to the announcements made on April 2.

From a cyclical perspective, the only good news is the drop in oil prices. At least for importing countries, the analysis is more nuanced for the U.S., where shale oil producers have announced cutbacks in investment spending. The core CPI, excluding energy and food, is also slowing to 2.8% as consumer choices reduce discretionary spending. For example, airfare prices plunged 5% after a -4.6% decline in February. Producer prices are also adjusting downward, although the underlying indices remain above 3% year-on-year. The thorn in the Fed's side remains households’ inflation expectations, which soar to 6.7% on a 1-year horizon according to the April Michigan survey.

In the equity markets, volatility remains considerable. The VIX fluctuated between 32% and 60% from Monday to Friday. The 90-day pause triggers buybacks and double-digit daily performances on the Nasdaq on Wednesday, allowing a 4% rebound for the week. European stocks fell 2%, penalized by the euro's rebound to $1.14. The only firm trend concerns U.S. long-term rates. The 10-year yield rose by 55 bps last week, marking the largest weekly increase since 1982. Reallocations towards Bunds are accelerating, causing the German curve to flatten significantly in the long maturities. The 30-year bond is down 11 bps, in contrast to the 50 bps rise on the T-bond. The front end is under pressure in anticipation of a likely cut from the ECB and the drop in oil prices. The 2-year expected inflation (swap) closes at 1.37% on Friday, which seems extremely low. Sovereign spreads remain relatively stable, likely thanks to international flows into the euro. The OAT is quoted at 79 bps, up 4 bps. Outflows from high yield funds are accelerating in both Europe and the United States, although there are reallocations towards short credit strategies. The iTraxx Crossover ends a wild week below the 400 bp threshold.

Axel Botte

Main market indicators

G4 Government Bonds	14-Apr-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Bunds 2y	1.77%	0	-41	-31
EUR Bunds 10y	2.55%	-6	-33	+18
EUR Bunds 2s10s	77.2 bp	-6	+8	+49
USD Treasuries 2y	3.92%	+16	-9	-32
USD Treasuries 10y	4.46%	+28	+15	-11
USD Treasuries 2s10s	53.7 bp	+12	+24	+21
GBP Gilt 10y	4.7%	+8	+3	+13
JPY JGB 10y	1.34%	+22	-19	-2
€ Sovereign Spreads (10y)	**14-Apr-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
France	78 bp	-1	+6	-5
Italy	120 bp	-8	+5	+2
Spain	70 bp	-3	+7	+1
Inflation Break-evens (10y)	**14-Apr-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR 10y Inflation Swap	1.87%	-1	-22	-6
USD 10y Inflation Swap	2.32%	-2	-12	-14
GBP 10y Inflation Swap	3.17%	-10	-25	-36
EUR Credit Indices	**14-Apr-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR Corporate Credit OAS	123 bp	+6	+37	+21
EUR Agencies OAS	61 bp	+6	+13	-1
EUR Securitized - Covered OAS	57 bp	+8	+14	+1
EUR Pan-European High Yield OAS	424 bp	+26	+113	+106
EUR/USD CDS Indices 5y	**14-Apr-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
iTraxx IG	75 bp	-5	+18	+17
iTraxx Crossover	381 bp	-26	+71	+67
CDX IG	73 bp	-3	+17	+23
CDX High Yield	430 bp	-27	+83	+118
Emerging Markets	**14-Apr-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
JPM EMBI Global Div. Spread	388 bp	+4	+55	+62
Currencies	**14-Apr-25**	**1wk (%)**	**1m (%)**	**2025 (%)**
EUR/USD	$1.140	4.244	4.752	10.1
GBP/USD	$1.316	3.394	1.755	5.1
USD/JPY	JPY 143	3.701	4.192	10.3
Commodity Futures	**14-Apr-25**	**-1wk ($)**	**-1m ($)**	**2025 (%)**
Crude Brent	$64.7	$0.4	-$5.4	-12.1
Gold	$3 231.1	$260.5	$247.0	23.1
Equity Market Indices	**14-Apr-25**	**-1wk (%)**	**-1m (%)**	**2025 (%)**
S&P 500	5 363	5.70	-4.89	-8.8
EuroStoxx 50	4 875	4.70	-9.79	-0.4
CAC 40	7 232	4.40	-9.92	-2.0
Nikkei 225	33 982	9.14	-8.29	-14.8
Shanghai Composite	3 263	5.37	-4.58	-2.7
VIX - Implied Volatility Index	37.56	-20.05	72.53	116.5

Source: Bloomberg, Ostrum AM

Additional notes

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