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Markets validate an upturn

Key Points

- **Economic indicators improve despite the epidemic**
- **European stocks gained 3% last week, banks outperform**
- **Yields basically sideways, some steepening pressure**
- **Risk-on environment in credit and high yield**

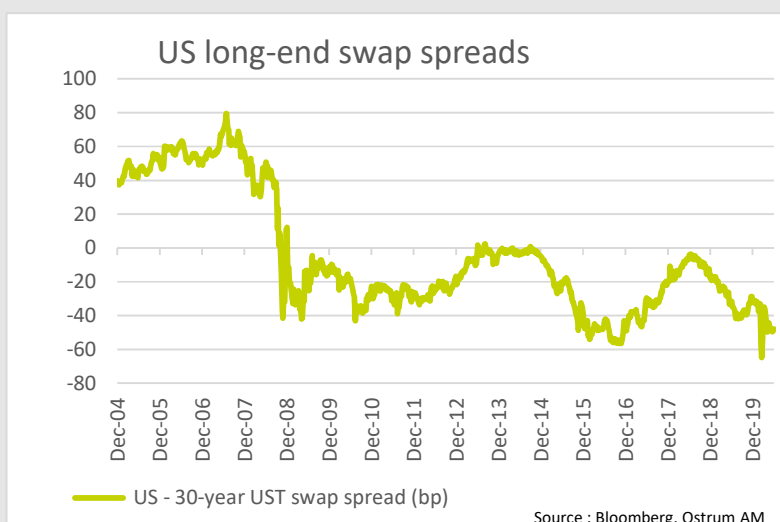
Economic surveys indicate a global economic upswing. Equities seem to validate recovery signals rising nearly 3% last week in Europe. Trading volumes were nevertheless limited ahead of US Independence Day.

The rise in equities did not spark tensions on bond yields although steepening pressure beyond 10 years maturities remain in both the US and the euro area. Sovereign spreads have narrowed. Credit spreads tightened across the board in both the US and Europe. Indeed, iTraxx IG shrank 8bp to 64bp at

last week's close. A pickup in inflows pushed high yield spreads tighter as well.

The US dollar remains a barometer of investor risk aversion. The rise in risk assets is accompanied by a decline in the value of the dollar against most currencies except for the Japanese yen. The greenback's drop favours emerging USD debt as spreads narrowed by a further 11bp last week to 461bp.

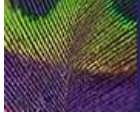
Chart of the week



Swap spreads are usually interested as indicators of risk aversion or systemic banking risk as was the case in 2008.

At the long end of the curve, the 30-year swap spreads also reflect the propensity of pension funds to hedge their duration risk via swap when balance sheets are constrained.

Current levels are close to 2016 lows at -48bp due to considerable borrowing needs for the US Treasury.



Surveys depict an upturn

Profit taking around the end of the first half of 2020 was swiftly undone by signs of an economic recovery. June data releases have been upbeat in most parts of the world. In the US, the ISM manufacturing index (52.6 in June) confirmed the upbeat tone in local Fed manufacturing surveys. The ISM survey stands at its highest level since May 2019. Rising new orders reflect higher domestic demand. The decline in delivery times indicates that activity along the supply chains is improving. Investment is likely the key to put an end to this unusual economic crisis. Shipments of capital goods rose 1.5% in May. The investment outlook for the next 6 months have taken a turn for the better in all local Fed surveys after a rough 3 months period. Light at the end of the tunnel so to speak. In turn 4.8mn workers returned to work in June. That said, the rapid increase in bankruptcies mean rising permanent job losses. Unemployment will stay above 10% for some time. Federal income transfers will have to be extended. Furthermore, the economic outlook remains subject to the sanitary situation, especially in the southern part of the country. New positive cases have accelerated above 50k per day, way above the March epidemic peak. The return of US protectionism against Europe and tensions around Hongkong security law entail other risk factors. In the euro area, activity is also showing signs of life. Household consumption in France and Germany even though retail sales are still below their pre-Covid levels. In China, the service sector (Caixin 58.4 in June) is up sharply from February lows.

Equities: up strongly at quarter start

Equities have resumed their uptrend after the half-year close. Improving economic news have taken center stage as markets paid less attention to incoming virus data. The Euro Stoxx 50 is up 2.8% in light volumes ahead of US public holiday last Friday. After a dreadful first half of year, bank stocks led markets higher with a 5% weekly return. Fed stress tests had nevertheless warned of increased loan loss provisioning for European banks with branches operating in the US.

The earnings season will begin shortly in the US in usual circumstances as 40% of US firms refuse to provide guidance on activity. Market reaction to earnings releases will likely be strong in case of disappointment. Valuations indeed (24x 2020 EPS) are not cheap enough to accommodate earnings downside. Total shareholder payouts have roughly been halved amid dividend cuts and reduced share

buybacks. Furthermore, the ban on short selling on some equity markets expired at the end of June. Activist funds would hence take the opportunity to weigh on weak companies' stock prices.

Rate volatility vanishes amid Fed actions

As concerns bond markets, minutes from the latest FOMC unveiled policymakers' hesitations to pursue yield curve control policies. In fact, the volatility on US rates has vanished and is now close to all-time lows. The MOVE index (50bp) is now less than 10bp above 2019 historical lows. Rate volatility has disappeared which may turn out to be a real issue for balanced fund investors seeking to hedge downside risks on risky assets. Steepening pressure has not subsided (+6bp on 5s30s) so that Treasuries are trading at wide asset swap spreads levels beyond 20 years' maturities at 47bp on 30-year tenors. Despite \$80b QE purchases from the Fed, the next round of fiscal stimulus may weigh on long-term yields. The US 10-year note yields around 0.70%. In the euro area, Bund yields drifted under the -0.40% threshold. Syndication of a Portuguese 15-year bond (mid-swap + 88bp) drew demand worth 10 times the amount issued (€4b). Sovereign bonds spreads keep narrowing. Italian BTPs trade through 170bp whilst Iberian debt spreads are still wide to year-end levels but back within 90bp.

Credit markets have followed on from the equity market uptrend. Activity in primary markets before summer recess and earnings season did slow the spread rally. Bond issuance totaled €19b last week capping a record quarter (€236b sold). Hence iTraxx (64bp; -8bp last week) performed better than cash corporate bond markets where spreads narrowed by 4bp to 145bp vs. Bunds. Investment flows into credit funds picked up after window dressing considerations slowed buying before half-year close. Financials outperformed last week. Investors also raised their high yield exposure. Flows are up noticeably at the start of 3Q 2020. Spread declined by 9bp to 523bp. Default rates remain low across Europe at about 1.5%. The magnitude of the crisis is such that bankruptcies will likely increase but the overall default rate may remain below 3-4% of speculative-grade debt.

The risk-on financial backdrop is obviously unfavorable to the US dollar. The greenback is depreciating against most currencies except for the Japanese yen. The euro is creeping higher towards \$1.13. Mexican peso and Brazilian real gained 3% last week. Lastly, it is worth mentioning that gold prices are stable despite rising risky asset prices.

Main Market Indicators

G4 Government Bonds	06-Jul-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.68 %	+1	-8	-8
EUR Bunds 10y	-0.43%	+5	-15	-24
EUR Bunds 2s10s	25 bp	+3	-7	-16
USD Treasuries 2y	0.16 %	+1	-5	-141
USD Treasuries 10y	0.7 %	+8	-19	-122
USD Treasuries 2s10s	54 bp	+7	-15	+19
GBP Gilt 10y	0.21 %	+5	-14	-61
JPY JGB 10y	0.04 %	+2	-1	+5
€ Sovereign Spreads (10y)	06-Jul-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	32 bp	-3	+2	+1
Italy	167 bp	-10	-2	+7
Spain	86 bp	-8	+2	+21
Inflation Break-evens (10y)	06-Jul-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	52 bp	+2	+2	-
USD TIPS	142 bp	+9	+16	-37
GBP Gilt Index-Linked	299 bp	+11	+5	-12
EUR Credit Indices	06-Jul-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	145 bp	-4	-9	+52
EUR Agencies OAS	55 bp	-2	-2	+11
EUR Securitized - Covered OAS	42 bp	-2	-3	+1
EUR Pan-European High Yield OAS	523 bp	-9	-12	+219
EUR/USD CDS Indices 5y	06-Jul-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	62 bp	-9	+1	+18
iTraxx Crossover	361 bp	-37	+21	+155
CDX IG	73 bp	-8	+5	+27
CDX High Yield	494 bp	-44	+51	+214
Emerging Markets	06-Jul-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	461 bp	-11	-38	+171
Currencies	06-Jul-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	\$1.132	+0.8	+0.23	+0.78
GBP/USD	\$1.250	+1.76	-1.58	-5.77
USD/JPY	¥107.55	+0.2	+0.67	+0.96
Commodity Futures	06-Jul-20	-1wk (\$)	-1m (\$)	YTD (\$)
Crude Brent	\$43.2	\$1.4	\$0.8	-\$19.3
Gold	\$1 785.3	\$15.4	\$87.8	\$262.5
Equity Market Indices	06-Jul-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	3 173	5.45	1.61	-1.79
EuroStoxx 50	3 350	3.66	-1.00	-10.54
CAC 40	5 085	2.83	-2.16	-14.93
Nikkei 225	22 714	3.27	-0.65	-3.98
Shanghai Composite	3 333	12.54	13.72	9.27
VIX - Implied Volatility Index	27.74	-20.13	8.11	101.31

Source: Bloomberg, Ostrum Asset Management

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