Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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Fed unveils its new policy framework

Key Points

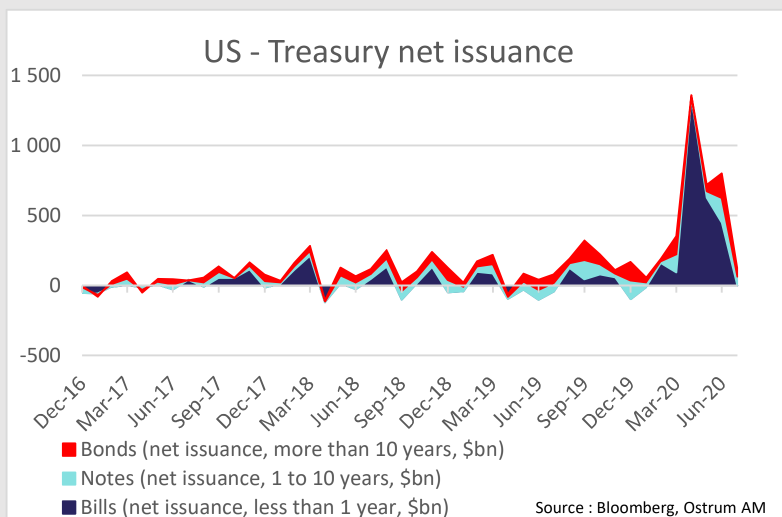
- **Fed ready to let inflation drift higher**
- **Steepening pressure in US bond markets**
- **Dollar weakness supports risky assets**
- **Credit and sovereign spreads well oriented**

The new definition of the Fed's inflation and employment objectives foreshadows monetary accommodation for years to come. After initial market hesitations linked to pre-Jackson Hole positioning, the US yield curve resumed steepening extending the August trend. The yield on 30-year yield topped 1.50% pulling European yields higher. Bund yields crept up above the -0.40% mark Sovereign spreads and swap spreads benefit from the risk-on environment. Iberian spreads hover about 80bp vs. Bunds.

Dollar weakness (euro trades at $1.19) is a boon for risky assets. The S&P posted a 3% weekly advance breaking through the 3500 threshold with slightly higher volatility (VIX at 24%). In Europe, stock indices were about flat for the week.

Credit spreads tightened modestly in the euro area IG space but European high yield (451bp vs. Bunds) narrowed by 12bp last week. More limited Fed support to credit markets may be a reason behind underperformance of US credit vs. Europe. Conversely, emerging debt (421bp vs. UST) benefits from favorable USD funding conditions.

Chart of the week



The yield curve steepened significantly in the US in August. In addition to the Fed's inflationary policy bias, the Treasury's issuance strategy may command a larger term premium.

In fact, at the height of the crisis, investor preference for liquid assets obliged the US Treasury to issue considerable amounts of T-Bills (more than $1.3T in net terms in May). The US Treasury will seek to lengthen the average maturity of federal debt by raising the share of long-dated bond issuance, which may lead to more significant curve steepening risk.

The Fed revises its policy framework

The Jackson Hole symposium is usually dedicated to economic policy debate between academics and policy practitioners outside of the FOMC meetings. It is hence somewhat surprising that Jerome Powell chose this conference to unveil the conclusions of the Fed's strategic review. The Federal Reserve has a mandate from the US congress to maximize sustainable employment in the context of price stability. The dual mandate is then translated into (more or less) explicit inflation and unemployment rate objectives by policymakers. According to policymakers, price stability corresponds to 2% annual inflation. The Fed will now target inflation of 2% on average "over time", that is over a long enough period to make up for subpar inflation in previous years. Jerome Powell refrained from stating an explicit formula for the new inflation target and the Fed will allow moderately higher inflation. The Fed's analysis of the economic cycle was also amended. The Fed will only react to shortfalls in employment from its maximum level. Assessing the sustainability of the current employment levels is no longer a requirement for policy setting. The concept of full employment is tied to a level of unemployment rate below which tensions along the supply chain become apparent. Tensions may result in higher inflation, longer delivery times, hiring difficulties and opportunity/productivity losses (less creation destruction). The latter element is quite problematic since the Fed no longer seems to target an economic equilibrium. Furthermore, the Fed seems no to worry about potential risks to financial stability stemming from continuous liquidity injections. In reality, it has become nearly impossible for the Fed to achieve simultaneous macroeconomic and financial equilibria. The watered-down economic goals is de facto recognition that the Fed is much more the US dollar Central Bank than it is the Central Bank of the US economy. Financing needs will be fulfilled whatever the costs in terms of household purchasing power.

Steepening pressure mounts

The US Treasury market reaction is consistent with the Fed's accommodative policy stance. The steepening trend initiated by prospects of increased long-term bond issuance is now fueled by expectations of higher inflation. The 5s30s spread thus broke early June highs of 122bp. TIPS outperformed so that the weekly rise in 10-year inflation breakevens (+10bp) exceeded that of comparable nominal bond yields (+7bp). Dollar weakness indeed may raise imported inflation. In addition, yield curve control policy has not been mentioned by Jerome Powell. The bond market may hence test the Fed's ability to withstand steepening pressure. There may be a yield level at which the Fed would be forced to intervene either by increasing the share of long bond purchases or by enforcing a ceiling on long-term yields. Speculative short positioning on long-term bonds is indeed accumulating fast.

US steepening pressure has led European bond yields higher. Bund yields trade above -0.40% whilst 30-year German yields turned positive again (+0.08%). Furthermore, EU bond issuance (AA-rated) will add to core bond supply. The funding of the SURE scheme will require issuance of €30-40b bonds this year and some €60b next year. The amounts borrowed in markets will be then loaned to member states in several installments. Italy and Spain will receive €27b and €21b respectively, which will reduce their issuance programs over the next two years. Peripheral sovereign spreads have room to come in further. Italy is trading near 145bp vs. Bunds and Iberian debt hovers about 80bp. Conversely, core sovereign issuers and France will face competition from new EU bond issuance. Such market backdrop will foster further yield/spread convergence across sovereign bond markets to the benefit of peripheral countries.

European credit spreads narrow

Despite seasonal drop in trading volumes and less primary market activity, the ECB's presence is still being felt in bond markets. Corporate bond purchases total about €4b in August in CSPP and around €1-2b in PEPP. Final investor demand slowed somewhat towards month end. Euro investment grade bond spreads shrank by 14bp in August to 114bp vs. German Bunds. Subordinated financials debt offered outperformance against defensive sectors. The rally in European high yield continued (-45bp). The inversion of the spread curve is slowly being unwound. The tightening trend is less pronounced in US bond market, which could be traceable to less buying from the Fed compared with the ECB. Institutional credit demand (via ETF and credit funds) nevertheless remains quite solid in the US.

In equity markets, the S&P gained 3% last week printing new record highs beyond the 3500 mark. Long speculative positions in Nasdaq futures is expanding fast. US technology leadership is setting the trend in stock markets. The sector represents more than a quarter of the US market capitalization and, despite elevated valuations, a trend reversal is unlikely in the short run. In Europe, stock indices face headwinds from the stronger euro ($1.19) and lower technology weighting. That said, the improvement in a number of economic surveys sparked an upturn in cyclical sectors including basic resources and leisure.

Main Market Indicators

G4 Government Bonds	31-Aug-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.65 %	+3	+6	-5
EUR Bunds 10y	-0.40%	+9	+13	-21
EUR Bunds 2s10s	26 bp	+7	+7	-16
USD Treasuries 2y	0.13 %	-2	+2	-144
USD Treasuries 10y	0.69 %	+4	+16	-123
USD Treasuries 2s10s	56 bp	+6	+14	+22
GBP Gilt 10y	0.31 %	+10	+21	-51
JPY JGB 10y	0.05 %	+2	+3	+6
€ Sovereign Spreads (10y)	**31-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	30 bp	+0	-3	0
Italy	149 bp	+6	-5	-11
Spain	81 bp	-1	-6	+15
Inflation Break-evens (10y)	**31-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	61 bp	+2	+1	-
USD TIPS	179 bp	+11	+24	+1
GBP Gilt Index-Linked	314 bp	+7	+15	+3
EUR Credit Indices	**31-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	114 bp	-2	-11	+21
EUR Agencies OAS	47 bp	-2	-4	+3
EUR Securitized - Covered OAS	36 bp	-2	-5	-5
EUR Pan-European High Yield OAS	451 bp	-13	-36	+147
EUR/USD CDS Indices 5y	**31-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	54 bp	+0	-6	+10
iTraxx Crossover	321 bp	-6	-55	+115
CDX IG	66 bp	0	-5	+21
CDX High Yield	368 bp	-16	-75	+88
Emerging Markets	**31-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	419 bp	-3	-27	+129
Currencies	**31-Aug-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.195	+1.16	+1.7	+6.41
GBP/USD	$1.338	+1.99	+2.5	+0.91
USD/JPY	¥105.8	+0.6	+0.27	+2.63
Commodity Futures	**31-Aug-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$45.7	$0.0	$1.8	-$16.0
Gold	$1 973.1	$56.7	$2.3	$450.3
Equity Market Indices	**31-Aug-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 506	2.19	7.19	8.53
EuroStoxx 50	3 273	-1.78	3.09	-12.62
CAC 40	4 947	-1.21	3.42	-17.24
Nikkei 225	23 140	0.67	6.59	-2.18
Shanghai Composite	3 396	0.30	2.59	11.33
VIX - Implied Volatility Index	24.52	9.61	0.25	77.94

Source: Bloomberg, Ostrum Asset Management

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