

STRATEGY WEEKLY

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Powell calls for 3-year status quo on rates

Key Points

- Fed announces rate status quo until 2023
- BoE to explore negative rates
- Caution on stocks, hold on to long duration stance
- Credit offers most attractive risk-reward

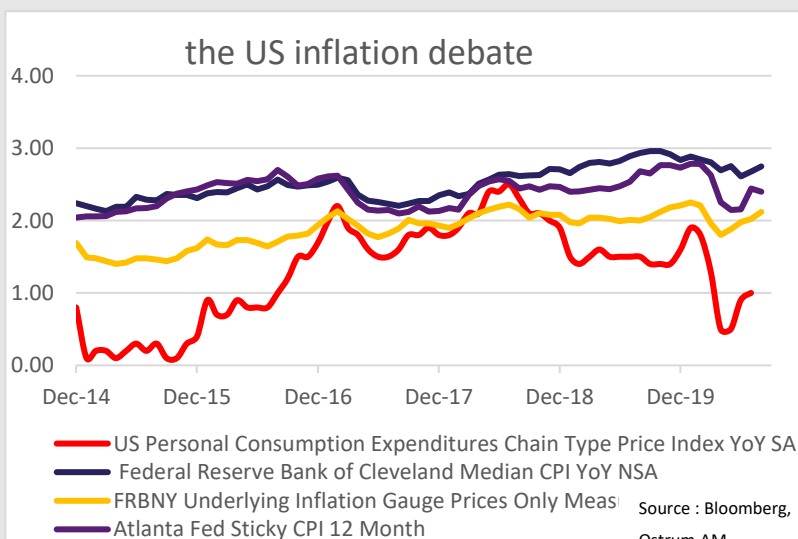
In keeping with the Jackson Hole announcements, the Fed now projects three years of zero Fed Funds rates. The upward revisions in economic projections did not translate into gradual unwinding of monetary accommodation. Furthermore, the BoE is now exploring negative interest rates.

Bond yields have eased slightly but the flight-to-safety bid may be rather traceable to Nasdaq weakness rather than monetary policy decisions. The technology-heavy index is now 13% off its early

September highs. European bank stocks have been under pressure. T-note yields keep trading below 0.70% as Bund yields drift towards previous lows. Peripheral spreads resist, in spite of a downgrade to the outlook on Spain's sovereign rating. Credit spreads remain stable about 115bp over Bunds.

The risk aversion backdrop is quite supportive of the Japanese yen. The dollar rebounded on Monday as equity indices nosedived.

Chart of the week



Over the past few years, the Fed frequently judged inflation to be too low relative to its 2% goal. The recent change in the price stability objective to average inflation targeting highlights the "need" for faster price gains.

The paradox is that many inflation measures produced by Fed researchers depict a very different backdrop. Indices produced by Cleveland, New York and Atlanta Fed researchers show inflation above 2% and even acceleration in prices since the start of the pandemic. Households also perceive price tensions according to several surveys. Hence, is higher US inflation indeed desirable?

Fed status quo until 2023

The FOMC left monetary policy unchanged last week. The Jackson Hole symposium had laid out a new framework justifying a prolonged period of monetary easing. The Fed is indeed distancing itself from its dual mandate of price stability and maximum employment. Interest rate projections hence fit the new policy framework as a broad majority of FOMC participants foresee zero interest rates until 2023. Growth projections have been revised significantly. Activity will contract by 3.7%y in 4q20 (against -6.5%y forecasted in June). GDP will expand at a 4% clip next year and stay above potential (seen around 1.7-2%) for the next two years. Inflation measured by the PCE deflator will converge to 2% by 2023 according to policymakers. Forecasts for unemployment rate see joblessness falling to 7.6% by year-end. Policy status quo was not a unanimous decision. Two FOMC members dissented. Robert Kaplan is opposed to calendar forward guidance unrelated to economic developments. Neel Kashkari argued conversely that the Fed should commit to low rates as long until core inflation rises sustainably to 2%. Furthermore, bond markets apparently anticipated some form of QE twist announcement, meaning a greater proportion of long-term bond purchases. But reinvestments of Fed portfolio proceeds are indeed done proportionally to Treasury bond auction sizes and residential investment needs no extra stimulus at this juncture.

In the UK, the BoE is studying the possibility of negative rates starting in 4q 2020 to supplement its asset purchase facility, which may be augmented by a further £100b next November. Brexit negotiations have gone nowhere as deadline looms in mid-October. The BoE will soon enter damage control mode ... to the detriment of sterling which may depreciate against the euro and safe haven including the Japanese yen.

Clouds gathering on the horizon

Current monetary policy may not be enough to stave off financial and political risks threatening the world economic recovery. The deterioration in the sanitary situation in Europe, political events including Brexit and the US elections, China-US tensions on personal data use and rich Nasdaq valuations paint a dark picture of the fourth quarter.

Hold on to long duration

Nasdaq volatility may spark financial conditions tightening and hence weigh on economic growth. The rise in VIX and the yen rebound do highlight increasing risk aversion. In this context, it is worth maintain a long duration stance across Gilt, Bund and T-note markets.

The preferred maturity is 10 years. The yields on 2-year bonds are well anchored by low policy rates, except maybe in the UK. Hence 2s10s spreads may have room to shrink. Beyond 10-year maturities, the deterioration in public finances and inflation risks still warrant steepening exposure, in particular in the US. Inflation breakeven levels argue for a constructive stance on linkers.

Peripheral sovereign bonds are protected by central banks so far. Spreads on 10-year bonds hover about 150bp in Italy and 80bp in Iberian markets. Yet there is no place for complacency. S&P sent a stark reminder of this by lowering the outlook on Spain's rating. The EU postponed its inaugural bond sale linked to the SURE program to mid-October. Executions risks on European recovery plans are material. The EU may opt for a 10-year bond issue, which may compete with French OATs. Institutional investors may choose to lengthen their maturities as long bonds still offer modestly positive yields.

Banks under pressure

European banks (-8% last week) have been on rating agencies radar screen for some time due to the dire economic situation and their sovereign bond exposure. Regulatory leverage ratio easing and the resumption of dividend payments next year did little to prevent another sell-off in bank stocks that appeared traceable to money laundering allegations. Volumes of bank stocks traded on Friday hint at some form of capitulation. Sector consolidation remain a priority. Cyclical sectors sensitive to Covid developments also traded lower. On the broad euro Stoxx index, earnings forecasts have stabilized but price action is still driven by the US equity market. If anything, outflows from the US equity funds have accelerated in the latest leg higher. The put-call volume ratio on technology stocks is better balanced. Nasdaq 1000 is off some 13% from its early September peak. The only support to equity valuations comes from the return of M&A flows. About two-thirds of deals are being financed in cash even as rich equity valuations normally command a greater share of equity swaps. The decline in interest rates orchestrated by central banks this year did contribute to a sharp rise in private-sector leverage, which likely slowed the credit spread rally of late. The IG credit asset class nevertheless offers the most attractive risk-reward trade-off over a short-term horizon thanks to monetary policy support. On this note, it is interesting to see that the Fed will be able to trade corporate bonds directly with buy side investors via platforms.

Main Market Indicators

G4 Government Bonds	21-Sep-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.73 %	-2	-4	-12
EUR Bunds 10y	-0.53%	-5	-2	-35
EUR Bunds 2s10s	20 bp	-3	+2	-22
USD Treasuries 2y	0.14 %	0	-1	-143
USD Treasuries 10y	0.66 %	-1	+3	-125
USD Treasuries 2s10s	53 bp	-1	+4	+18
GBP Gilt 10y	0.16 %	-4	-5	-67
JPY JGB 10y	0.02 %	-1	-2	+3
€ Sovereign Spreads (10y)	21-Sep-20	-1w k (bp)	-1m (bp)	YTD (bp)
France	27 bp	-1	-3	-3
Italy	145 bp	-5	0	-15
Spain	78 bp	+2	-2	+13
Inflation Break-evens (10y)	21-Sep-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	47 bp	-4	-9	-
USD TIPS	163 bp	-3	-1	-16
GBP Gilt Index-Linked	313 bp	-7	+10	+2
EUR Credit Indices	21-Sep-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	113 bp	-2	-2	+20
EUR Agencies OAS	47 bp	-1	-1	+3
EUR Securitized - Covered OAS	33 bp	-2	-4	-8
EUR Pan-European High Yield OAS	435 bp	-3	-27	+131
EUR/USD CDS Indices 5y	21-Sep-20	-1w k (bp)	-1m (bp)	YTD (bp)
iTraxx IG	57 bp	+2	+2	+13
iTraxx Crossover	322 bp	+0	-11	+116
CDX IG	53 bp	-15	-14	+8
CDX High Yield	370 bp	+21	-21	+90
Emerging Markets	21-Sep-20	-1w k (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	408 bp	+6	-13	+117
Currencies	21-Sep-20	-1w k (%)	-1m (%)	YTD (%)
EUR/USD	\$1.174	-0.97	-0.53	+4.53
GBP/USD	\$1.278	-0.9	-2.23	-3.66
USD/JPY	¥104.77	+0.66	+1.07	+3.64
Commodity Futures	21-Sep-20	-1w k (\$)	-1m (\$)	YTD (\$)
Crude Brent	\$41.5	\$1.9	-\$3.5	-\$20.1
Gold	\$1 904.6	-\$53.5	-\$27.0	\$381.8
Equity Market Indices	21-Sep-20	-1w k (%)	-1m (%)	YTD (%)
S&P 500	3 247	-4.02	-4.41	0.52
EuroStoxx 50	3 161	-4.70	-3.03	-15.60
CAC 40	4 792	-5.14	-2.13	-19.84
Nikkei 225	23 360	-0.20	1.92	-1.25
Shanghai Composite	3 317	1.16	-1.89	8.75
VIX - Implied Volatility Index	28.80	11.41	27.77	109.00

Source: Bloomberg, Ostrum Asset Management

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