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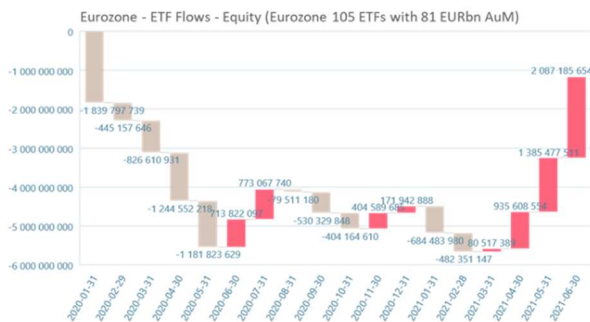
● Topic of the week: emerging countries after the Fed

- The acceleration of inflation and the normalization of US real interest rates are forcing the central banks of emerging countries to raise their key interest rates.
- Those that changed their monetary policy most quickly were those for which exchange and interest rates were the most resilient.
- Social tensions and the electoral calendar may postpone tax reforms that put pressure on long-term interest rates. Key challenge for emerging central banks is to maintain credibility and financial stability.

● Market review: Dust settles across markets

- US reaches compromise deal on infrastructure;
- Equity indices head north again amid lower volatility;
- Yield curves steepen modestly;
- Credit spreads still insensitive to risk-free yields.

● Chart of the week



Investors' appetite for Eurozone equities is increasing again. After having recorded very large flows on the US equity markets at the beginning of the year, investors are shifting, with the usual delay, on the European markets.

These flows, if maintained, are likely to keep upward pressure on prices.

● Figure of the week

18

Source: OECD

Wait times for chips delivery is at a record 18 weeks as shortage deepens. The historical norm is closer to 10-to-12 weeks.



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• **Topic of the week**

Emerging countries after the Fed

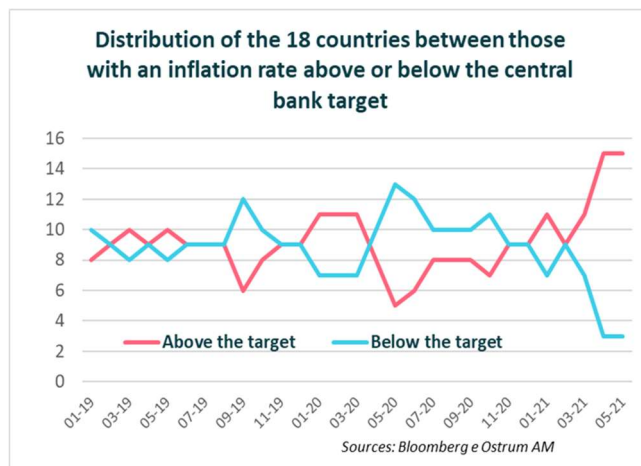
This week, we are focusing on the reaction of the emerging markets after the FOMC of June 15-16, 2021. EM remain sensitive to any changes in US monetary policy direction. Emerging countries are faced with a tightening of the Fed's stance as well as an increasing inflation. Those who changed their monetary policy most quickly were those for whom exchange rates and interest rates were the most resilient.

The issue

Rising commodity prices, including food and energy, have led to rising inflation in many emerging countries.

Food and energy are important in emerging countries' consumer price indices (CPIs). On average, food accounts for 25% and energy for 10% of CPIs. However, these weights vary by country. In India, the weight of food is 45% and 40% in the case of the Philippines.

The chart below shows that out of 18 major countries, 15 currently have an inflation rate above the central bank target since April 2021.



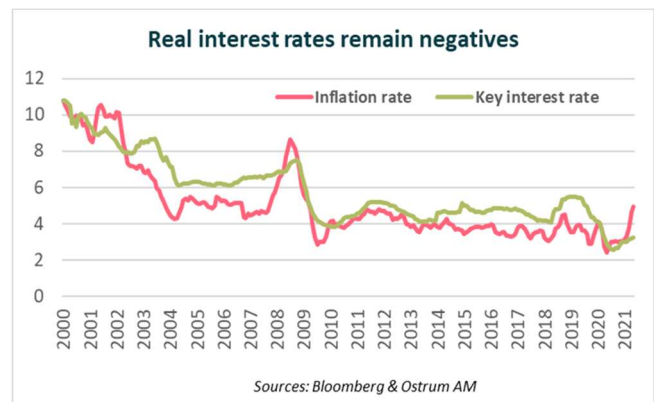
While some central banks, such as those in Brazil, South

Africa, Ukraine or Russia, have begun to tighten their monetary policies or have announced as early as the end of last year, their attention to doing so, others have been more cautious.

The resurgence of the pandemic, as well as the uncertainty about the transitory aspect or the persistence of rising inflation, continue to weigh on central bank decisions.

Asia is an exception. Inflation remains below the central bank target overall (except in the Philippines, Pakistan, India and South Korea) and allows the region's central banks to support the recovery in activity.

The chart below illustrates the situation. The average inflation rate in the same 18 major countries is higher than their policy rates.



Negative real rates threaten their financial stability as their financial assets become less attractive, especially their currencies. The risk is that the depreciation of currencies via the effects of contagion to inflation will eventually lead to the rise of domestic interest rates.

Borrowing costs increase, making it more difficult for countries with high budget deficits such as Turkey, South Africa and Brazil to refinance their debt.¹

Central banks in emerging countries are therefore in a complex situation. They should accompany the recovery of their activity, but the acceleration of inflation forces them to react in order to preserve their credibility and macroeconomic stability.

Post-FOMC Emerging Markets Response

Following the FOMC of June 15-16, 2021, it was mainly the foreign exchange market that was most affected by the Fed's decision.

¹ According to the IMF, fiscal deficit forecasts for 2021 are expected to be: -8% of GDP for Brazil, -10.6% of GDP for

South Africa and -5.7% for Turkey.

EM currencies depreciated against the US dollar, linked to the strengthening of the greenback (chart below). The ICE dollar index recorded a performance of almost 2% between June 16 and 22, 2021.

However, there are different behaviors across currencies.

Asian currencies were more resilient overall than currencies in Latin America, Eastern Europe and Africa. This is probably due to better recovery prospects than in other areas and stronger peg to the yuan. Despite rising commodity prices, the currencies of net producing and exporting countries, such as the rand (ZAR), have been penalized. This reflects the strong sensitivity of these countries to the Fed's

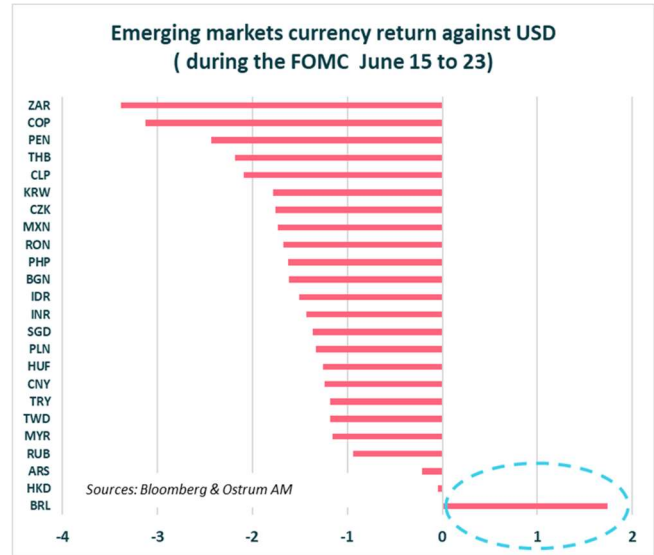
The currencies that have been more resilient are those whose central banks have less expansionary monetary policies.

monetary policy decision.

The currencies that have been more resilient are those whose central banks have less expansionary monetary policies.

This was the case for the Brazilian Real (BRL), which posted a 1.6% performance against the USD. On 16 June 2021, the Brazilian central bank (Bacen) decided to raise its key interest rate (Selic) by 75 bps to 4.25%.

Since March, Bacen has increased its Selic rate by 225 bps due to the acceleration of inflation which reached 8.1% in May, exceeding its target of 3.75% (+/- 1.5%).

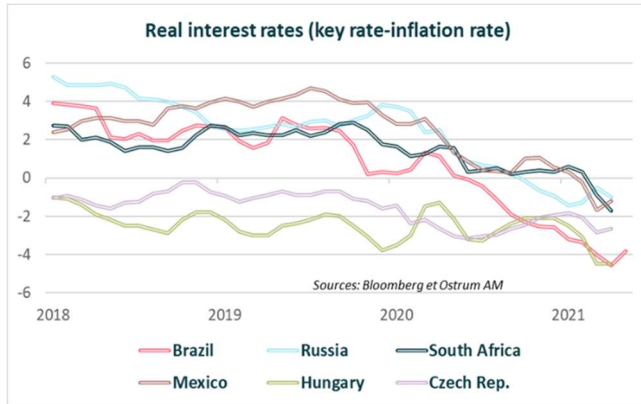


In its minutes from its Monetary Policy Council, known as COPOM, on 15-16 June, Bacen indicated that the possibility of further monetary tightening was on the table. The improved growth outlook has significantly reduced downside risks to inflation. Fiscal risk remains an issue despite recent improvements.

In other words, the Bacen's reading of its domestic economic situation is comparable to that of the Fed. Bacen normalizes its real interest rates to reflect the current state of activity which is more robust.

Among the Eastern European currencies, the ruble (RUB) depreciates the least against the greenback. The Russian Central Bank has raised its benchmark rate by +125 bps since 12 February 2021 to 5.5%.

The acceleration of inflation and the change in the Fed's stance forced the hand of other central banks. This is the case of the Hungarian central bank, which also raised its benchmark interest rate last week by 30 bps to 0.9%, and the Mexican central bank, which unexpectedly raised its key rate by 25 bps to 4.25%, from the Czech Republic, which raised its key interest rate to 0.5% by 25 bp at the beginning of June, and the South Korean central bank, which could also follow suit.



The chart above shows that real rates have stabilized in countries where central banks have tightened monetary policy.

South Africa is the exception. Its negative real rates continue to fall, which explains the poor performance of the rand (ZAR) against the dollar since the last FOMC.

From the beginning of the year until June 14, 2021, before the Fed's last FOMC, the rand was the currency with the best performance (almost 7%) against the greenback. The explanation lies in its current account, which reached nearly 3% of GDP (4-quarter moving average) thanks to the increase in commodity prices, particularly metals. The South African Central Bank has so far been reluctant to raise interest rates in order not to slow down the recovery. The Fed's beginning to normalize should force its hand.

Despite hikes, central bank policy rates remain at historically low levels.

In 2020, central banks in emerging countries had made aggressive rate cuts to limit the impact of the pandemic on business.

Central banks that are beginning to normalize their monetary policies, such as those of Brazil and Russia, are therefore starting from a low level of interest rates, which also allows them not to overly constrain the resumption of their activity (real interest rates remain negative) while stabilizing their financial markets.

On the sovereign debt market, the EMBIGD (dollar-denominated debt) index recorded a zero performance over the period from 15 to 23 June 2021. However, the investment grade segment (IG) outperformed by +0.5% compared to the high yield segment (HY) by -0.5%. A rotation is probably underway. From the beginning of the year until June 14, before the Fed's FOMC, the HY outperformed the IG (-2.9%) by 2.6%. Investors seem to favor the sovereign debt of highly-rated countries. Stay tuned...

After reaching a year-low of 329bp, the EMBIGD spread moved slightly from 7bp to 336bp.

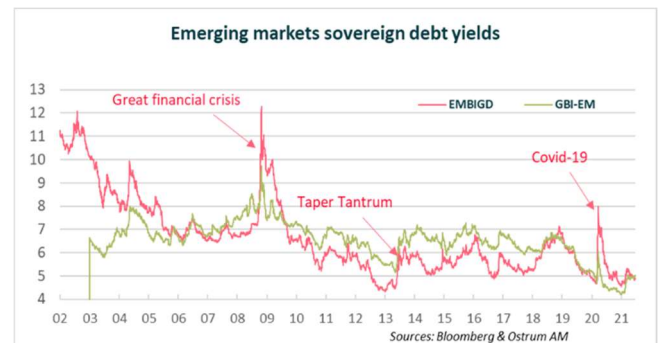
On local debt markets, the GBI-EM Index posted a -0.3% performance over the same post-FOMC period. It should be noted that for the first time since May 2020, its 5% yield slightly exceeds the EMBIGD yield of 4.9%, reflecting the increase in local interest rates.

However, as shown in the graph below, the response has been contained in relation to previous shocks and in particular in relation to the 2013 "Taper Tantrum". This is because the Fed is still a long way from a "Tapering".

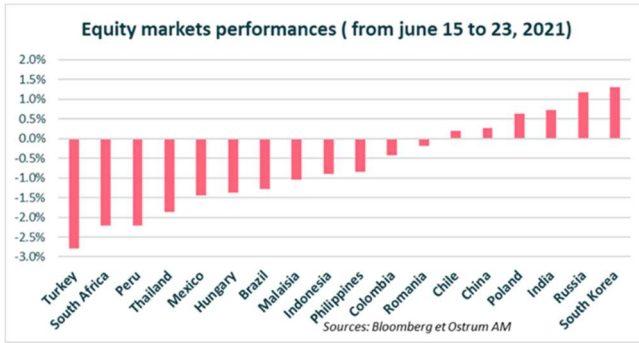
On the other hand, the circumstances are different: EM debt in hard currencies has decreased significantly. At the end of 2019, according to BIS data, more than 80% of public debt is denominated in local currencies and at fixed rates. This reduces sovereign credit risk.

Despite increases, central bank policy rates remain at historically low levels.

External positions (current accounts) are in surplus and foreign reserves are comfortable due to higher commodity prices, which reduces the external vulnerability of countries.

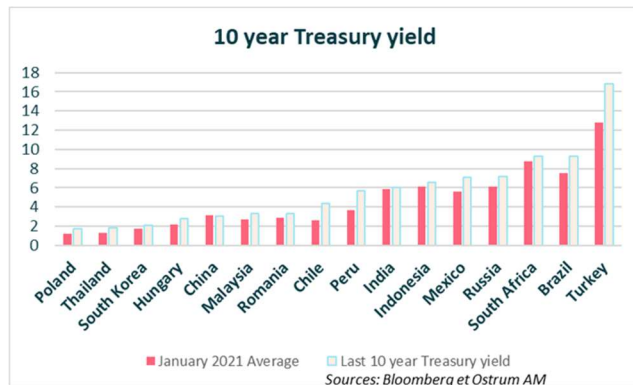


On the equity market, the impact was also more limited, than on currencies, as shown in the chart below. Countries with the most affected currencies recorded positive stock market performances such as South Korea or Chile.



Finally, the last point to emphasize is that the political and social context is tense in emerging countries.

With the exception of countries with high budget deficits such as Turkey, Brazil and South Africa, long-term interest rates in Chile, Colombia and Peru also exceed their beginning-of-year levels (see chart below).



Social tensions have erupted in Chile and Colombia over the implementation of unpopular reforms to clean up public spending. In Peru, it was uncertainty about the outcome of the presidential election that caused interest rates to rise. The probable future president, Pedro Castillo, raises fears because his intentions remain unclear on the country's economic program.

The social tensions linked to the economic consequences of the pandemic, as well as the electoral calendar, risk postponing crucial fiscal reforms to the stabilization of public finances in many countries. This should put pressure on their long-term interest rates. That is why the main challenge facing central banks in emerging countries today is to guarantee financial stability by preserving their credibility.

Zouhoure Bousbih

• **Market review**

Dust settles across markets

Modest curve steepening as equities reach fresh record highs

Equity markets resumed their upward trend as economic surveys confirmed the economic upturn in Europe in particular. The indices are trading at record highs in the United States, where the Nasdaq is clearly benefiting from a lull in bond yields after the storm initiated by the FOMC last week. The US dollar is weaker at the margin allowing the euro to move closer to \$ 1.195. Low default rates do not prevent profit taking in European high yield space. The trend remains, however, for spread compression in the CDS markets. Conversely, the US speculative-grade debt market continues to perform well in the wake of upbeat US stock indices.

The bipartisan budget deal in the United States reached on Thursday night is welcome as it may contribute to higher potential output growth. However, the infrastructure spending plan, cut back to \$ 579 billion, is far less ambitious than the Biden Administration's initial proposal of \$ 2.3 trillion. However, it includes large investments in public transport, electric charging stations, water management and telecommunication networks. At this juncture, it is still uncertain whether a qualified majority of 60 senators can be achieved. Furthermore, the other part of the infrastructure package focused on household access to better health care and education will be harder to push through Congress, especially as Republican senators camp may use the weapon of the debt ceiling to redefine the contours of this second infrastructure bill. On the economic front, signs of a slowdown have emerged in the housing market. Demand is restrained by both the sharp rise in house prices, an obvious lack of available supply and signs of a pickup in mortgage rates which have risen above 3% on 30 year maturities. Total home sales thus fell below the 6400k threshold on an annual basis in May. In turn, the private consumption deflator stood at 3.9% in May. The core PCE gauge (3.4%) is at its 30-year peak.

In the euro zone, growth is strengthening in France and Germany. The PMI indices as well as the INSEE and IFO surveys are on the right track in June. The first disbursements linked to the European aid plan have been brought forward to July. However, the M3 money aggregate slowed down to 8.3% in May as credit to the private sector siled below 4%. The banks' funding demand of € 110 billion during the TLTRO-III in June may make it possible to redress the flow of credit or, failing that, will favor carry strategies on the bond markets. The extension to March 2022 of the exemption of bank reserves held with the ECB from the

leverage ratio fostered demand for long-term loan from the European Central Bank.

Global monetary policy is gradually shifting towards tightening. The Brazilian and Czech central banks have indeed raised rates following more hawkish messages from both the Canadian (reduction in QE) and Norwegian Central Banks (increase expected after the summer). However, the BoE adopted a somewhat cautious stance as the emergence of the delta variant delays the full reopening of the UK economy. Andy Haldane tried to push for less asset purchases one last time.

Despite the hawkish tone of the last FOMC, the Fed Board is looking to dampen volatility. Comments by Jerome Powell and John Williams, emphasizing the likely transitory nature of the acceleration in consumer prices, contributed to a re-steepening of the US yield curve. The 2-5 year spread widened to 66bp after a series of subpar bond auctions. The 10-year T-note closed last week above 1.50%. The scarcity effect of US collateral remains problematic, so that recourse to the New York Fed's repo facility is still rising reaching \$ 813 billion late last week. The rise in the reverse repo rate to 5bp continues to attract strong demand from money market funds. Break-even inflation rates rebounded by 9bp on 10-year inflation swap. The rise in household expectations from the University of Michigan consumer survey undoubtedly fed the upward bias. In Europe, Bund yields increased in the wake of the T-note at the very end of the week to -0.15%. Mediocre auctions on the 15-year German debt midweek pointed to potential for higher yields. Meanwhile, the risk of a new 20-year Italian debt syndication has likely weighed on the 10-year BTP spread (108bp). The spreads on Spain and Portugal bonds are holding up as the possibility of downward revisions to their issuance programs started to emerge.

Credit remains insensitive to the direction of the interest rates. The average spread on investment grade corporate credit is unchanged at 82bp on both the euro and the dollar markets. Flows now seem to balance out on short-term credit in euros (1-3 year maturities) thanks to the return of final investors. The euro high yield market had to absorb large primary market issuance and alleged governance issues among German real estate companies. However, the compression of spreads by rating categories pushed the iTraxx Crossover through the 230bp level (-21bp in June). Speculative rating spreads moved wider by 9bp on the week to around 300bp. Conversely, US high yield tightened by 6bp in a rare move of disconnect between the US and euro markets.

Finally, upward pressure on the dollar weakened, which contributes to an appreciation of risky assets. Equities remain supported by a clear recovery in fund inflows in Europe and a favorable outlook for the upcoming earnings season. In fact, growth and quality factors outperform.

Axel Botte
Global strategist

● Main market indicators

G4 Government Bonds	28-Jun-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.65 %	+0	+1	+5
EUR Bunds 10y	-0.16%	+1	+2	+41
EUR Bunds 2s10s	48 bp	+0	+1	+35
USD Treasuries 2y	0.26 %	+1	+12	+14
USD Treasuries 10y	1.51 %	+3	-8	+60
USD Treasuries 2s10s	125 bp	+2	-20	+46
GBP Gilt 10y	0.77 %	0	-3	+57
JPY JGB 10y	0.06 %	+1	-3	+4
€ Sovereign Spreads (10y)	28-Jun-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	35 bp	+1	0	+12
Italy	108 bp	+3	-2	-3
Spain	64 bp	+1	-2	+2
Inflation Break-evens (10y)	28-Jun-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	134 bp	+4	-2	-
USD TIPS	236 bp	+8	-9	+37
GBP Gilt Index-Linked	349 bp	+4	-8	+49
EUR Credit Indices	28-Jun-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	83 bp	+0	-3	-9
EUR Agencies OAS	41 bp	-1	+3	+0
EUR Securitized - Covered OAS	32 bp	-1	+2	-1
EUR Pan-European High Yield OAS	306 bp	+13	+3	-52
EUR/USD CDS Indices 5y	28-Jun-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	46 bp	-2	-4	-2
iTraxx Crossover	227 bp	-11	-21	-15
CDX IG	47 bp	-3	-3	-3
CDX High Yield	270 bp	-11	-18	-24
Emerging Markets	28-Jun-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	333 bp	-5	-5	-18
Currencies	28-Jun-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	\$1.194	+0.18	-2.07	-2.33
GBP/USD	\$1.393	-0.01	-1.85	+2.01
USD/JPY	¥110.66	-0.44	-0.73	-6.65
Commodity Futures	28-Jun-21	-1wk (\$)	-1m (\$)	YTD (\$)
Crude Brent	\$76.2	\$1.3	\$7.5	\$24.8
Gold	\$1 783.5	\$0.3	-\$120.2	-\$110.8
Equity Market Indices	28-Jun-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	4 281	2.74	1.82	13.97
EuroStoxx 50	4 123	0.25	1.28	16.04
CAC 40	6 628	0.38	2.22	19.39
Nikkei 225	29 048	3.70	-0.35	5.84
Shanghai Composite	3 606	2.19	0.16	3.84
VIX - Implied Volatility Index	16.05	-10.29	-4.24	-29.45

Source: Bloomberg, Ostrum Asset Management

Additional notes

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