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ECB reaching out for banks

Key Points

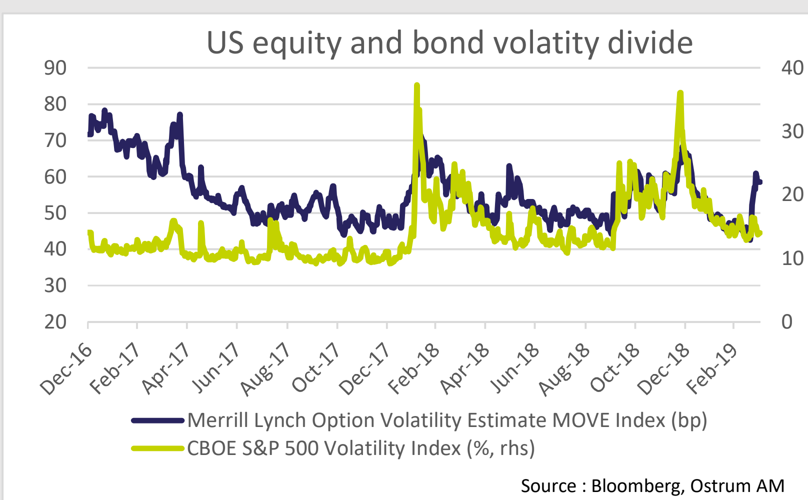
- **Equity markets up 2% last week**
- **Banking sector: ECB will take account of margin impact of negative rates**
- **T-note yields stabilise above 2.40%**
- **Dollar strengthens against euro, yen**
- **CDS indices tighten, favourable backdrop for cash corporate credit**

Equity markets resumed rising last week. European indices gained as much as 2.5%. The rebound in bank stocks appears traceable to Mario Draghi's comments hinting at possible changes to the deposit facility rate scheme. Equity markets were also upbeat in Asia and in North America.

In bond markets, rising stocks encourages profit taking. The yield on 5-year US notes rose 9bp. The 2s5s spread is slowly dis-inverting and 10s30s steepening trend came to a halt. Demand for TIPs remains soft so that breakeven inflation rates failed to respond to higher crude prices. Bund (-0.04%) keep trading in negative territory. Some selling appeared at the back-end of the euro yield curve. Sovereign spreads are a touch wider than a week ago. In turn, CDS indices sparked moderate tightening in corporate credit spreads. The spread on iTraxx Crossover declined to 265bp. Bank subordinated debt benefitted from ECB announcement.

Dollar is strong against major currencies. The yen depreciated towards 111 against the greenback. The euro dropped to $1.12.

Chart of the week



Calm returned to equity markets ahead of the earnings season.

Contrary to equity volatility, implied volatility on fixed income instruments increased from extremely low levels before the FOMC.

The change of heart of the Fed in march triggered a sharp repricing of bond yields as 10-year note yields dipped towards 2.40%.

The decline in rates tend to raise fair value on equities, which tends to signal lower risks ahead.

The ECB will reform the deposit facility

Mario Draghi's speech on March 27 was just another occasion to reaffirm that accommodative monetary policy is here to stay given the lower economic momentum in the euro area. The most important point of the ECB's communication pertains to the impact of negative rates on bank margins. Monetary policy transmission to the real economy requires that banks are able to lend profitably to the private sector. Some institutions must keep reducing their cost base, reduce their bad loan portfolios or raise capital but some aspects of monetary policy have undoubtedly been counter-productive.

Since June 2014, the ECB charges a negative rate on reserves with the ECB held by banks. The interest rate, lowered a total of four times in the last five years, has been set at -0.40% since March 2016. Bank liquidity holdings on the ECB deposit facility currently amount to close to €600b. Total excess liquidity in the euro area banking system stands at €1,820b at the end of March. Tougher regulation as concerns bank liquidity and the implementation of asset purchase programmes have contributed to a costly build-up of cash reserves. Furthermore, the scarcity of risk-free assets maintain repo rates below the deposit facility rate. Hence a reform to the ECB's deposit facility scheme appears overdue. Interest rates offered by banks on retail and corporate deposits are positive on average. One could imagine that part of the reserve holdings (linked to regulatory requirements) may be remunerated at zero percent or tied to the ECB refinancing rate. Such a measure would likely raise the floor on interbank rates without changing the marginal rate applicable to cash reserves beyond a bank-specific threshold.

Flattening pressure in euro yield curve

The German yield curve flattened in the wake of Draghi's speech. The yield on 30-year Bund hit a 2019 low point at 0.54% before bouncing back above 0.60% on profit-taking flows. Despite unattractive valuations (10-year yield at -0.03%), the market trend and technical backdrop suggest holding on to a long duration stance in euro bond portfolios and a 2s10s flattening bias. In turn short-dated swap spreads may continue to widen.

In the United States, economic data releases will set the tone this week after the Fed's dovish change of heart sparked a bond rally. Final investor flows point to moderate profit taking in the asset class. Carry on treasuries is quite poor when measured against 3 months LIBOR, which remains near 2.60%. Bullish sentiment on US Treasuries may also prevent another downshift in bond yields. Should a bull run occur, the technical level signalling acceleration to the downside would be 2.28%. Neutrality on US rates will prevail this week. Unwinding of steepeners in 5s30s and 10s30s last week does not change our long-held steepening view at the back-end of the curve. As concerns UK Gilts, the Brexit saga and a lack of term premium warrant caution.

Rebound in stocks

Monetary accommodation continues to dominate the impact of a lacklustre economic backdrop in the euro area. Equity indices are up more than 2% over the past week. The dividend yield on stocks averaging 3.5% in Europe remains a key argument in favour of the asset class. That said, some investors have been hedging equity exposure locking in large price returns in the first quarter. It is true that implied volatility (and hence hedging cost) remains at low levels. EPS forecasts for 2019 are consistent with earnings growth in the vicinity of 5-10%. Bank stocks, which have been de-rated for a long period due to the low rate environment, staged a timid rally. The pickup in bank stock performance may not signal a shift to 'value' theme as flows into growth funds remain stronger. The cyclical situation does favour growth defensive sectors. In turn energy sector (exhibiting low beta to broad market gauges) remains underpinned by elevated oil prices.

The US equity market gained more than 1% last week. The underperformance to Europe is likely a by-product of a strong dollar (euro trades near $1.12). Earnings forecasts will adjust to the downside as the US economy goes through a soft-patch in the first quarter. Downward revisions ahead of the earnings season was worth about 0.5% of current quarter's EPS on the S&P 500 universe. Energy (+0.4%) and telecommunication services (+0.7%) were the only sectors to be revised up. A rebound in profitability is expected in the second quarter. Lastly, positioning of hedge funds and asset managers is no issue at this juncture and may not prevent further run-up in prices.

As concerns corporate bond markets, the low level of sovereign bond yields keeps supporting allocation flows into euro IG corporate credit. The average spread on IG bonds stands at 123bp vs. Bunds. The tightening trend in CDS indices signals potential narrowing in cash spreads on both IG and high yield markets in the US and in Europe. European high yield offers a 400bp premium over Bunds.

In emerging bond markets, Fed policy is quite supportive. Spreads on external debt denominated in US dollars stand at 350bp vs US government bonds and local-currency bond yields adjust lower in keeping with the rally in treasuries. This continues to attract considerable investor interest.

Main Market Indicators

G4 Government Bonds	01-Apr-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.6 %	-3	-9	+1
EUR Bunds 10y	-0.03%	+0	-21	-27
EUR Bunds 2s10s	57 bp	+4	-12	-28
USD Treasuries 2y	2.33 %	+9	-23	-16
USD Treasuries 10y	2.49 %	+9	-26	-20
USD Treasuries 2s10s	16 bp	+1	-4	-3
GBP Gilt 10y	1.05 %	+6	-25	-23
JPY JGB 10y	-0.07 %	+1	-7	-8
€ Sovereign Spreads (10y)	**01-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	40 bp	+2	+0	-7
Italy	253 bp	+0	-2	+3
Spain	117 bp	+4	+15	-1
Inflation Break-evens (10y)	**01-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	100 bp	-2	+9	+0
USD TIPS	191 bp	+4	-5	+20
GBP Gilt Index-Linked	321 bp	-4	+14	+4
EUR Credit Indices	**01-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	123 bp	+0	-5	-29
EUR Agencies OAS	55 bp	+1	-2	-5
EUR Securitized - Covered OAS	54 bp	+1	-2	-9
EUR Pan-European High Yield OAS	401 bp	-7	+1	-112
EUR/USD CDS Indices 5y	**01-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	63 bp	-7	+0	-26
iTraxx Crossover	260 bp	-23	-19	-94
CDX IG	62 bp	-8	+2	-26
CDX High Yield	341 bp	-14	-4	-110
Emerging Markets	**01-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	351 bp	0	+14	-64
Currencies	**01-Apr-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.121	-0.95	-1.37	-2.12
GBP/USD	$1.314	-0.33	-0.48	+3.08
USD/JPY	¥111.33	-1.37	+0.5	-1.5
Commodity Futures	**01-Apr-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$68.8	$2.0	$3.7	$14.2
Gold	$1 290.5	-$32.3	-$3.0	$8.9
Equity Market Indices	**01-Apr-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 859	2.15	1.96	14.03
EuroStoxx 50	3 385	2.57	2.21	12.79
CAC 40	5 406	2.75	2.67	14.27
Nikkei 225	21 509	2.54	-0.43	7.47
Shanghai Composite	3 170	4.18	5.89	27.12
VIX - Implied Volatility Index	13.71	-16.04	1.03	-46.07

Source: Bloomberg, Ostrum Asset Management

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