

11 June 2019 /// n°19-2019

ECB monetary overkill

Key Points

- Draghi ever more dovish ahead of June FOMC
- Risk assets rebound
- Bund yields at all-time low, Portugal 5-year yields in negative territory
- Credit should keep tightening in the wake of euro sovereign rally

Equity markets went up sharply last week. US stock markets price in Fed easing after disappointing job growth in May. T-note yields plunged temporarily below 2.10% before moving back up slightly.

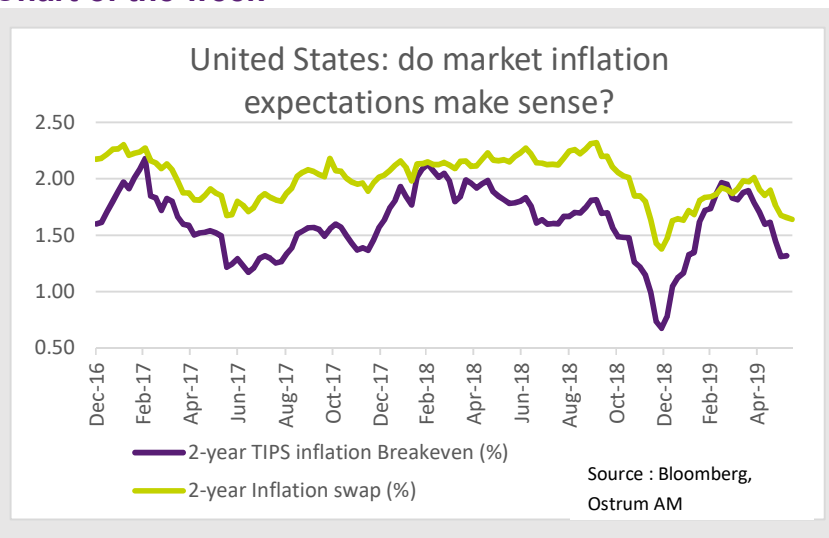
The ECB sent dovish signals resulting in significant narrowing in sovereign and credit spreads. The yield on German Bunds hit new lows at -0.23%. Italy, under pressure from the European Commission, is said to be willing to avoid clash. Ten-year BTP spread came in within 260bp. TLTRO-III conditions turned out more favourable than anticipated.

In the UK, Gilts outperformed. Boris Johnson threatened not to pay the Brexit bill that Theresa May negotiated earlier on. Rating agencies somewhat surprisingly claimed that failure to pay would not be considered default.

The euro is up above \$1.13 as investors' attention now turns to the next Fed meeting.

New tariffs on Mexican goods have finally been avoided. Mexican peso erased recent weakness. Spreads on emerging debt narrowed.

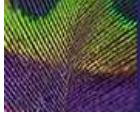
Chart of the week



James Bullard (Fed) considered that the decline in inflation breakevens justifies cutting rates. The breakeven derived from 2-year TIPS stands at 1.30% and inflation swap rates trade at 1.64%.

However, most economists forecast inflation close to 2% over the two-year timeframe. Our own model projects 2.05%.

Flight to quality likely reduced inflation breakevens. If so, receiving actual realized inflation should produce excess returns going forward.



Draghi's dovish legacy

The ECB turned out to be even more dovish than we had expected last week. Current monetary policy remains unchanged but the pricing of the next TLTRO-III includes an incentive mechanism that is quite favourable to euro area banks. The interest rate on 2-year maturity loans will be variable. The maximum rate will be refi rate plus 10bp. The low rate will be deposit rate plus 10bp. Banks for which net lending is growing will get the bonus rate if credit rises by 2.5% over the next 2 years. For banks (Italian and Spanish institutions notably) with declining lending, curbing the pace of decline will be enough to benefit from the low rate. It is hence quite likely that most banks using TLTRO-III financing will benefit from the minimum rate (deposit rate plus 10bp spread). It is worth noting that Draghi hinted at discussions to cut rates further. Furthermore, a tiering mechanism for interest rates on bank reserves would reduce the negative effect of further cuts on banking margins. The only risk faced by the ECB may be the lack of interest of German and French banks for TLTRO-III. Demand shortfall would reduce ECB balance sheet from September and contribute to a rebound in the euro. The Fed's response will obviously be critical.

The June 19 FOMC is much awaited by financial market participants. Markets price in fully 75bp worth of cuts over the year to come. Many concluded that Jerome Powell's commitment to 'appropriate' action foreshadowed a rate cut. It could be overreaction to market weakness in May and the ongoing trade war. Job growth slowed last month and GDP is expanding at a softer pace this quarter than in 1q19 (3%). That said, the Fed's estimate for potential growth is 1.75%. The current slowdown is thus reversion to potential output. Powell risks being too dovish relative to the Fed's dual mandate and identified financial stability risks or triggering another drawdown in equity markets by maintaining the rate status quo announced in March. Fed independence is dubious in the context of the resumption of net Treasury bond purchases from October. A dovish scenario remains our central case. Whilst the Mexico crisis was resolved swiftly, escalation in the China-US trade feud continues to be a source of volatility in markets.

In the UK, Boris Johnson, the leading candidate to replace Theresa May, announced that the UK will not pay the Brexit deal owed to EU during the transition period. Non-payment of €44b liabilities is not considered default by rating agencies. France made it clear that it disagrees.

Markets beg from monetary easing

Rate forecasts have created stress in repo markets particularly for 'special' securities. The yield on 10-year notes dipped under 2.10% late last week. Such market context contributed to a steeper curve. The 5s30s spread widened further which emphasizes both directionality embedded in 5-year bonds and long-term risks. Inflation-linked bonds point to an unlikely future inflation outcome in our opinion. Two-year breakevens are trading near 1.30% whilst core CPI however about 2%y. To make sense of such levels, one has to assume repeated negative shocks on oil prices for instance.

In Europe, the ECB's stance pushes sovereign spreads tighter, including that on Italian bonds despite the launch of excessive deficit procedure by the European Commission. The government appears willing to avoid a clash with the EC but refuses to pencil in the promised VAT hike. In any case, the 2020 budget shortfall amounts to €23b or 1.5pp of GDP. That said, spreads have eased. As even Portuguese bond yields with 5-year maturity now trade in negative territory, investors are forced into buying Italian or Greek debt. However, long-term bond spreads will continue to reflect challenges faced by Italian public finances.

Equities rebounded last week buoyed by expectations of Fed easing and dovish Draghi. This is a bit of a paradox at a time when the flow picture remains unfavourable. Downward earnings revisions continue which makes the rally look even more artificial. Sector performance in the US market shows strength in high-beta space including technology hardware (+6% last week) in spite of the ongoing trade war. Retail also outperformed. Short covering partially fed the rally. In Europe, the rise in the euro limited the upside on equity markets.

In credit markets, the sharp narrowing in CDS spreads foreshadowed spread tightening across cash corporate bond markets. Indeed, iTraxx IG spreads (61bp) retraced two-thirds of the May widening (+15bp). A turnaround is indeed visible in euro IG cash markets where spreads have come in by 7bp last week. Financials outperformed slightly but spread tightening is rather homogenous across credit sectors. High yield benefitted from stronger investor risk appetite. The speculative-grade rally resulted in 35bp spread tightening last week in Pan-European markets. That said, recent data suggests that high yield fund outflows, continue.

Main Market Indicators

G4 Government Bonds	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.67 %	-2	-5	-6
EUR Bunds 10y	-0.23%	-3	-19	-47
EUR Bunds 2s10s	44 bp	0	-13	-42
USD Treasuries 2y	1.94 %	+5	-33	-55
USD Treasuries 10y	2.16 %	+3	-31	-53
USD Treasuries 2s10s	22 bp	-3	+2	+2
GBP Gilt 10y	0.85 %	-5	-28	-43
JPY JGB 10y	-0.11 %	-1	-6	-11
€ Sovereign Spreads (10y)	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	35 bp	-5	-5	-12
Italy	254 bp	-18	-19	+4
Spain	81 bp	-7	-22	-37
Inflation Break-evens (10y)	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	79 bp	-7	-21	#VALEUR!
USD TIPS	173 bp	-3	-15	+2
GBP Gilt Index-Linked	347 bp	+8	+16	+29
EUR Credit Indices	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	122 bp	-7	+6	-30
EUR Agencies OAS	53 bp	-2	-1	-7
EUR Securitized - Covered OAS	48 bp	-2	-3	-15
EUR Pan-European High Yield OAS	385 bp	-35	-17	-128
EUR/USD CDS Indices 5y	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	60 bp	-7	-7	-28
iTraxx Crossover	268 bp	-28	-21	-86
CDX IG	60 bp	-7	-5	-28
CDX High Yield	347 bp	-31	-10	-103
Emerging Markets	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	354 bp	-30	+2	-61
Currencies	11-Jun-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.132	+0.64	+0.73	-1.18
GBP/USD	\$1.272	+0.26	-1.76	-0.2
USD/JPY	¥108.57	-0.31	+0.53	+1
Commodity Futures	11-Jun-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$62.4	\$0.4	-\$7.2	\$7.5
Gold	\$1 326.2	\$2.7	\$25.8	\$44.6
Equity Market Indices	11-Jun-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 895	3.27	0.47	15.48
EuroStoxx 50	3 406	2.17	1.34	13.48
CAC 40	5 413	2.76	1.61	14.43
Nikkei 225	21 204	3.90	-0.66	5.94
Shanghai Composite	2 926	1.23	-0.46	17.32
VIX - Implied Volatility Index	16.15	-4.83	0.69	-36.47

Source: Bloomberg, Ostrum Asset Management

Writing



AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

Legal information

This document is intended for professional clients in accordance with MiFID. It may not be used for any purpose other than that for which it was conceived and may not be copied, distributed or communicated to third parties, in part or in whole, without the prior written authorization of Ostrum Asset Management.

None of the information contained in this document should be interpreted as having any contractual value. This document is produced purely for the purposes of providing indicative information. This document consists of a presentation created and prepared by Ostrum Asset Management based on sources it considers to be reliable. Ostrum Asset Management reserves the right to modify the information presented in this document at any time without notice, and in particular anything relating to the description of the investment process, which under no circumstances constitutes a commitment from Ostrum Asset Management.

Ostrum Asset Management will not be held responsible for any decision taken or not taken on the basis of the information contained in this document, nor in the use that a third party might make of the information.

Figures mentioned refer to previous years. Past performance does not guarantee future results. Any reference to a ranking, a rating or an award provides no guarantee for future performance and is not constant over time. Reference to a ranking and/or an award does not indicate the future performance of the UCITS/AIF or the fund manager.

Under Ostrum Asset Management's social responsibility policy, and in accordance with the treaties signed by the French government, the funds directly managed by Ostrum Asset Management do not invest in any company that manufactures, sells or stocks anti-personnel mines and cluster bombs.

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

In the E.U. (outside of the UK and France): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. Italy: Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no. 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carree, 7. Floor, Frankfurt am Main 60322, Germany. Netherlands: Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. Sweden: Natixis Investment Managers, Nordics Filial (Registration number: 616405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: Natixis Investment Managers, Sucursal en España, Serrano nº90, 8th Floor, 28006, Madrid, Spain.

In France: Provided by Natixis Investment Managers International – a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland SARL, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the U.K.: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not to be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). The Fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market Counterparties as defined by the DFSA. No other person should act upon this material. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Japan: Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 34F., No. 68, Sec. 5, Zhongxiao East Road, Xinyi Dist., Taipei City 11065, Taiwan (R.O.C.), license number 2018 FSC SICE No. 024, Tel. +886 2 8789 2788.

In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Ostrum Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 5 Shenton Way, #22-05 UIC Building, Singapore 068806.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.

In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only.

In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Latin America: Provided by Natixis Investment Managers S.A.

In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18.627.

In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors.

In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. Past performance information presented is not indicative of future performance.

Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

All amounts shown are expressed in USD unless otherwise indicated.



www.ostrum.com

Ostrum Asset Management

Asset management company regulated by AMF under n° GP-18000014 – Limited company with a share capital of 27 772 359 euros

Trade register n°525 192 753 Paris – VAT: FR 93 525 192 753 – Registered Office: 43, avenue Pierre Mendès-France, 75013 Paris – www.ostrum.com

Tél. : 01 58 19 09 80