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Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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ECB permanently easing

Key Points

- **Draghi sparks another bout of desperate yield hunt**
- **Powell to signal easy bias**
- **Index-linked bonds are undervalued**
- **Credit spreads tightening, equity markets validating Central Bank dovish turn**

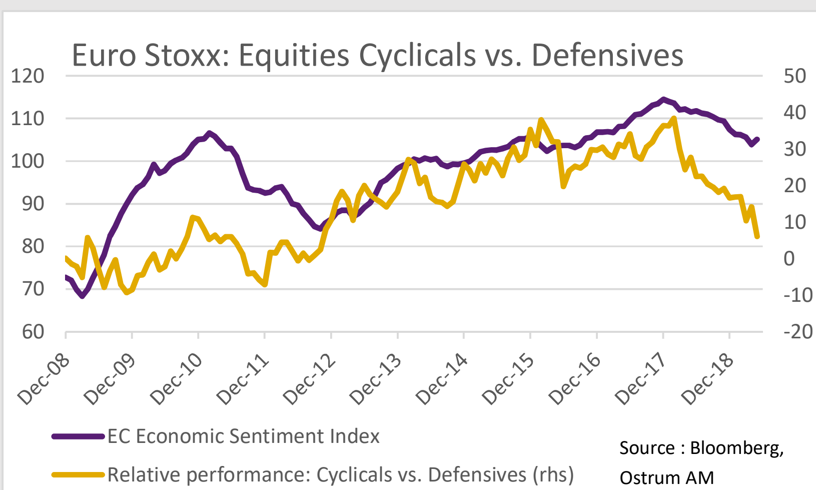
Central banks rival to find innovative ways to bring yields ever lower. Mario Draghi insisted in Sintra on the need to ease monetary policy. Jerome Powell will speak this week. A change in tone is quite likely.

Bond yields have made new historical lows. Bunds offers yields of *minus* 32bp. OAT bond yields are nil. Inflation breakevens have reached absurd levels at the short end of the curve in the euro area.

Sovereign spreads have converged lower over the past month despite underlying risks. Equity markets reacted favourably to the ECB's announcement. CDS credit spread tightening have led to similar movement in corporate cash bond markets, in particular in speculative-grade space.

Sterling decline highlights renewed concerns over the possibility of no-deal Brexit. The British Pound is trading below $1.26. The Aussie dollar is also weak on prospects for rate cuts.

Chart of the week



Despite international turmoil, European markets are up some 12-14% in 2019.

The rebound is in part the flipside of the weakness in the fourth quarter of last quarter but it is somewhat surprising that outperformance from defensives has continued.

In parallel, investment flows into funds exposed to the growth theme also remain quite strong to the detriment of value.

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Powell and the market's guidance

The Federal Reserve will meet this week. Anxiety fanned by trade war and the ECB's willingness to pursue "easing" may push the Fed to preannounce an interest rate cut to be implemented relatively shortly. The Fed has seemingly become an agent of financial markets. Monetary easing is by no means justified by the domestic situation. Unemployment is about a full percentage point below its equilibrium level. Inflation is close to target, although the deflator is tracking 1.5%a due to transitory factors. Growth will likely hover about 2% at annual rate in the three months to June. Retail sales foreshadow a sharp pickup in durable goods' spending. The latest decline in oil prices raises consumers' purchasing power. It is true that the international backdrop, including events in the Persian Gulf, weighs on sentiment as shown by the sharp decline in the Empire State index.

Thus, the Fed will adjust its communiqué by reiterating its commitment to sustain the expansion via appropriate action. A rate cut in June will be hard to justify but the dovish bias will sure be reinstated. The change will only confirm the U-turn signalled by the end of quantitative tightening by September.

The Fed's stance will also be influenced by Draghi's latest remarks. The possibility of new monetary easing was clearly outlined in Sintra. A rate cut is the first option although the resumption of asset purchases could turn out to be necessary to avoid balance sheet contraction if TLTRO-III take-up is less than anticipated. The situation ahead of this week's FOMC draws comparisons with that of March 2016. APP extension to non-bank corporate bonds and 20b addition operations per month led Janet Yellen to postpone a large part of the scheduled monetary tightening. The drop in the market's inflation expectations will likely be the Fed's argument to justify the new policy stance.

Undervalued linkers

Inflation breakeven rates (10-year TIPS at 164bp) trade at levels that make no sense given the inertia in core consumer price inflation. The decline in oil prices reduces current inflation but underpins demand growth thereafter. Furthermore, the recurrent softness in goods prices is traceable to positive globalisation factors instead of a shortfall in demand. That said, renewed interest in inflation-linked bonds is visible in ETF inflows. If the Fed were to surprise markets by cutting rates on Wednesday, TIPS appear well positioned to benefit. Usually, to alter economic behaviour, it is necessary to go beyond expectations. Hence, our recommendation to maintain a constructive stance on index-linked securities, including in European markets where breakevens have turned very negative on short-term maturities.

Hold on to long Bund stance

Duration positioning remains closely tied to curve flattening trend in the euro area. Bunds are trading near -0.32%, which may emphasize expectations of further QE and algorithmic and CTA trading activity. The 30-year Bund auction tomorrow may prove an acid test for investor demand. It is quite unlikely that lots of institutional accounts would have interest in buying 30-year bonds yielding about 0.30%. In US bond markets, the major adjustment could occur in the 2-year maturity bracket or even the 5-year group whilst steepening continues beyond this point.

In parallel, reach for yield suppress spreads on all sovereign debt. Yields on 10-year OATs are nil, Spain bonds with 6-year maturity are negative and 5-year PGBs also offer negative yields. The Italian situation, with the possibility of excessive deficit procedure being launched in early July, has not discouraged demand for BTPs. The spread is down to 240bp. The 2020 budget is far from clear but flows keep being channelled onto the only liquid sovereign debt offering positive yields on intermediate maturities. Two-year maturities remain relatively protected by the new TLTRO-III series. Beyond that, questions regarding the sustainability of Italian public debt will maintain long-term spreads elevated.

Relentless reach for yield

Equities are buoyed by the monetary policy outlook despite negative economic sentiment. Defensives and growth sectors outperform, which can lead to excessive optimism and positioning on both these investment themes. The outperformance of defensives appears at odds with the rise in indices. The absence of volatility in the context of continued final investor outflows hints at a precarious market equilibrium. Dividend yield remains nevertheless a strong argument in favour of equities compared with insignificant corporate bond yield levels. Corporate credit had been included in the asset purchase programme after non-resident holders began to sell. One should not rule that the ECB intervenes in equity markets at some point just like the BoJ, HKMA in the past or Central Banks acting like sovereign wealth fund (SNB).

In the euro area, credit markets are still underpinned by institutional demand and recent tightening in synthetic credit which move more quickly. Investment grade spreads hover about 121bp vs. Bunds. High yield spreads have shrunk by 12bp in the past week to 373bp.

Lastly, in currency markets, the possibility of Brexit without a deal exerts considerable downward pressure on sterling.

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Main Market Indicators

G4 Government Bonds	18-Jun-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.76 %	-9	-11	-15
EUR Bunds 10y	-0.32%	-9	-22	-56
EUR Bunds 2s10s	44 bp	+0	-10	-41
USD Treasuries 2y	1.85 %	-8	-35	-64
USD Treasuries 10y	2.05 %	-9	-34	-63
USD Treasuries 2s10s	20 bp	-1	+1	+1
GBP Gilt 10y	0.81 %	-5	-23	-47
JPY JGB 10y	-0.12 %	-2	-7	-13
€ Sovereign Spreads (10y)	**18-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	33 bp	-2	-6	-14
Italy	243 bp	-20	-34	-7
Spain	71 bp	-10	-27	-46
Inflation Break-evens (10y)	**18-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	74 bp	-5	-19	#VALEUR!
USD TIPS	165 bp	-7	-18	-7
GBP Gilt Index-Linked	338 bp	-9	+8	+20
EUR Credit Indices	**18-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	121 bp	-1	+2	-31
EUR Agencies OAS	52 bp	-1	-3	-8
EUR Securitized - Covered OAS	48 bp	-1	-3	-15
EUR Pan-European High Yield OAS	373 bp	-12	-24	-140
EUR/USD CDS Indices 5y	**18-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	57 bp	-4	-9	-31
iTraxx Crossover	263 bp	-6	-20	-91
CDX IG	59 bp	-2	-6	-29
CDX High Yield	344 bp	-8	-12	-106
Emerging Markets	**18-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	361 bp	+7	+1	-54
Currencies	**18-Jun-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.119	-1.24	+0.19	-2.3
GBP/USD	$1.255	-1.44	-1.4	-1.58
USD/JPY	¥108.46	0	+1.39	+1.11
Commodity Futures	**18-Jun-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$62.5	$0.2	-$8.8	$7.6
Gold	$1 344.7	$16.2	$68.5	$63.1
Equity Market Indices	**18-Jun-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 924	1.34	2.27	16.66
EuroStoxx 50	3 458	1.67	0.94	15.21
CAC 40	5 516	1.99	1.43	16.60
Nikkei 225	20 973	-1.09	-1.31	4.79
Shanghai Composite	2 890	-1.22	0.27	15.89
VIX - Implied Volatility Index	15.12	-5.44	-5.26	-40.52

Source: Bloomberg, Ostrum Asset Management

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