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ECB: an incoherent monetary package?

Key Points

- **ECB: tiering and deposit rate cut**
- **QE criticised by ECB policymakers**
- **Lower risk aversion: gold, VIX and yen down**
- **Confirmation of equity rebound, emerging debt and CDS spreads narrow**

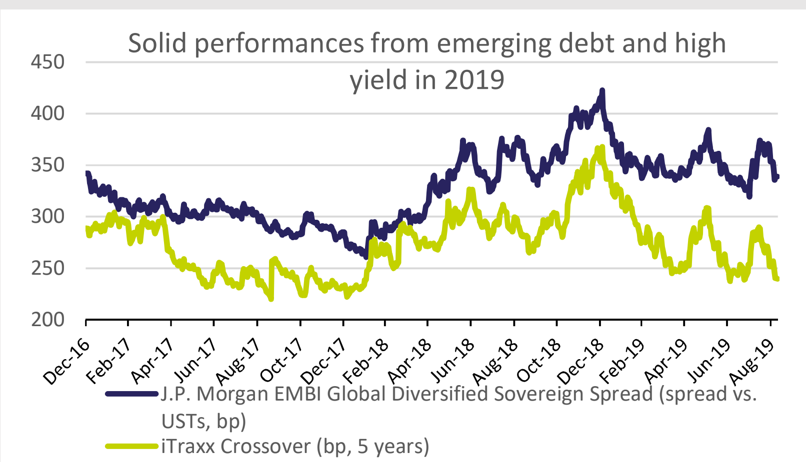
Risky assets benefitted from positive news as China and the US announced that trade talks will resume in early October.

Equities went up 2% in Europe and the US last week. Long-term bond yields drifted higher towards -0.60% on Bunds and 1.60% on US notes. Yield curves steepened slightly.

Depreciation in the Japanese yen (106.5 vs. the USD), lower implied equity volatility and cheaper gold all point to a reduction in investor risk aversion. Credit spreads have moved up by just 2bp. European high yield retraced a large part of its widening in August. CDS indices still narrowed in keeping with optimism seen across world equity markets.

Emerging debt resists the current Argentinian crisis, likely helped by a broad-based decline in the US dollar last week. The euro is trading about $1.10.

Chart of the week



Source : Bloomberg, Ostrum AM

Arguably, this year's economic conditions were not particularly favorable to strong performance in risky assets, especially high yield and emerging debt.

Monetary easing initiated by the PBoC and the Fed early on echoed in several parts of the world, so that impediments to global growth did not stop investors from reaching for yield.

Indeed, iTraxx XO (European high yield proxy) is trading at tight levels near 240bp. Emerging debt denominated in USD despite ongoing crises in Argentina and Turkey has proven resilient. Spreads stand below 340bp vs. Treasuries.

Draghi's last dash

The ECB meets on September 12th. Policy decisions are much anticipated by market participants. At its Sintra's speech last June, Mario Draghi had clearly hinted at the possibility of ECB rate cuts and new asset purchases.

The ECB hence may cut its deposit rate by 10bp this week. Forward guidance pointing to interest rates at current or lower levels could be extended beyond the first half of 2020, leaving the door open for further rate reductions. The deposit facility scheme will evolve in a way to shield part of bank reserves from negative rates. A tiering system will be put in place to reduce downward pressure on bank intermediation margins. The deposit rate (currently set at -0.40%) would apply only on a fraction of bank reserves. The measure could be designed as a multiple of reserve requirements but it is a quite complex considering the heterogeneity of the euro area banking system.

The ECB will nevertheless face operational challenges affecting the monetary transmission channel with this new tool. If the amount shielded from negative rates is too large, bank liquidity demand will rise. Hence repo rates (in core markets especially) may increase and bank ('balance-sheet') savings scheme will expand to compete with existing money market funds. Interbank money rates may drift away from the deposit rate floor, which would reduce the ability of the ECB to stir interbank market rates and the euro exchange rate. The ECB likely has in mind the need to maintain Eonia rates anchored to the deposit rate (its main policy rate under current conditions). Hence the amount of liquidity charged at the penalty rate will remain very large indeed.

QE and TLTRO: an incoherent package

The possible resumption of quantitative easing purchases sparked controversy among ECB policymakers last week. Under its current design, QE is mainly a financial repression instrument, which failed to spur inflation or cope with financial stress (Italy's crisis in 2018). A new asset purchase programme appears unjustified at present on economic grounds, especially as TLTRO-III loans (starting this month) will likely be used by participating banks to make similar purchases of public- and private-sector debt securities. In fact, QE tends to lower yields, flatten curves and reduce spreads at a time when banks need to increase margins. Extension of CSPP eligibility criteria to include senior bank bonds could make sense and contribute to a more coherent policy package.

That said, many banks anticipate the implementation of new asset purchases worth €30-40b a month over a 9-12 months period in the fourth quarter. QE is hence quite consensus in the marketplace and the ECB may not have the luxury to disappoint market participants. Likewise, announcing QE this week may have the advantage to smooth the transition with the Lagarde ECB.

Risk aversion declines

In financial markets, the confirmation of a rebound in risky assets stems from positive developments out of China with trade talks with the US scheduled in October and another round of Brexit can-kicking. Gold, yen and implied volatility reacted to the downside. US indicators have also shaped market trends last week. Manufacturing is contracting but the service sector is showing signs of life. Unemployment rate is steady at 3.7% although job growth is set to slow. The sustained rise in unit labour costs (2.5%y in 2q19) despite solid productivity gains is still off the Fed radar screen. For that reason, a rate cut on September 18th is firmly on the table.

Western market equities went up 2% last week. European banks benefitted from expectation of policy aimed at mitigating the impact of negative rates. Shanghai (signs of de-escalation in Hong Kong) and Tokyo (cheaper yen) joined the party with 3% rally.

In bond markets, valuations have cheapened to a degree in part because of political developments cited above and critics regarding a new round of QE. The main 10-year yield references were up about 10bp from a week ago. T-note is trading near 1.60% on Monday. The yield on 30-year Bund hovers about 0%. Long-term bonds underperform so that 2-10y and 10-30y spreads widened last week.

Investment grade credit took a breather after a prolonged period of strong performance due to monetary policy expectations and desperate reach-for-yield investments from final accounts. The pick-up in primary market activity in early September likely weighed on pricing across IG credit space. Average spreads have hovered about 110bp against Bunds. Most A-rated bond yield less than zero percent. Inflows in high yield funds have continued as the equity upturn maintained a favourable backdrop for the asset class. In turn, CDS index iTraxx XO is trading near 240bp, which is in line with 2019 tightest levels.

As regards emerging markets, spreads have proven very resilient despite the Argentinian crisis. Final flows have picked in the last few weeks. Spreads (337 vs. US Treasuries) have fully erased the August spike.

Main Market Indicators

G4 Government Bonds	09-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.86 %	+7	+1	-25
EUR Bunds 10y	-0.59%	+12	-1	-83
EUR Bunds 2s10s	27 bp	+5	-1	-58
USD Treasuries 2y	1.58 %	+7	-7	-91
USD Treasuries 10y	1.63 %	+13	-12	-106
USD Treasuries 2s10s	5 bp	+5	-5	-15
GBP Gilt 10y	0.59 %	+18	+11	-69
JPY JGB 10y	-0.25 %	+2	-3	-25
€ Sovereign Spreads (10y)	09-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
France	31 bp	+0	0	-16
Italy	153 bp	-14	-85	-97
Spain	80 bp	-3	-3	-37
Inflation Break-evens (10y)	09-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	75 bp	+9	-2	-
USD TIPS	157 bp	+3	-8	-14
GBP Gilt Index-Linked	342 bp	+6	+10	+24
EUR Credit Indices	09-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	112 bp	+2	+4	-40
EUR Agencies OAS	50 bp	+0	-1	-10
EUR Securitized - Covered OAS	45 bp	-1	-1	-18
EUR Pan-European High Yield OAS	353 bp	-2	-44	-160
EUR/USD CDS Indices 5y	09-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	48 bp	-1	-9	-41
iTraxx Crossover	240 bp	-12	-42	-114
CDX IG	52 bp	-3	-8	-36
CDX High Yield	326 bp	-15	-30	-125
Emerging Markets	09-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	339 bp	-14	-13	-76
Currencies	09-Sep-19	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.105	+0.74	-1.44	-3.5
GBP/USD	$1.235	+2.09	+2.21	-3.15
USD/JPY	¥107.18	-1.22	-1.73	+2.31
Commodity Futures	09-Sep-19	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$62.7	$4.0	$4.5	$7.6
Gold	$1 500.9	-$45.1	-$4.9	$219.4
Equity Market Indices	09-Sep-19	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 974	1.61	1.88	18.62
EuroStoxx 50	3 495	1.82	4.84	16.45
CAC 40	5 589	1.75	4.90	18.14
Nikkei 225	21 318	3.39	3.06	6.51
Shanghai Composite	3 025	3.44	9.01	21.29
VIX - Implied Volatility Index	15.80	-16.75	-12.08	-37.84

Source: Bloomberg, Ostrum Asset Management

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