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STRATEGY WEEKLY

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The end of OPEC triggers financial Krach

Key Points

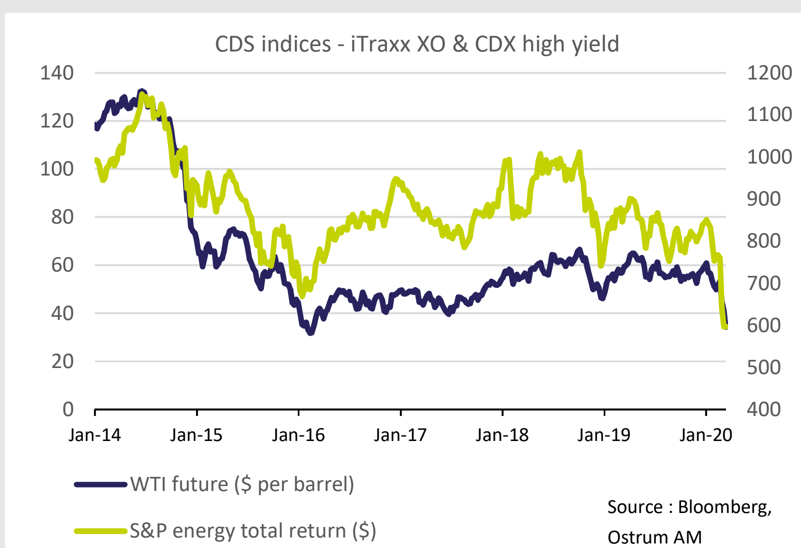
- **Collapse in European equities on Monday open (-10%)**
- **US equity markets suspended after 7% loss**
- **The absence of an OPEC+ deal sends oil tumbling below $35**
- **Credit index spreads skyrocket, peripheral sovereign under stress**

OPEC will soon cease to exist. Oil prices plummeted to less than $35 on Brent sparking disorderly unwinding of positions across global equity markets on Monday 9 March opening. European equity futures lost as much as 10% from Friday close. In turn US equity markets have been suspended after a 7% loss. VIX is trading way above 50%.

Flight to safety is massive. The yield on 10-year Bunds plunged below -0,80% whilst T-note yields hit an all-time intraday low of 0.31%. Liquidity of peripheral debt was extremely low on Monday as in credit markets. Credit spreads widened out violently in particular on macro hedging flows using iTraxx CDS indices.

Central bank panic is obvious ahead of the ECB meeting on Thursday 12 March. Easing measures will likely be implemented. The euro rose past $1.14. The Japanese yen is back in fashion as the chief safe haven currency. In turn carry trades including long Mexican peso holdings are being unwound.

Chart of the week



Source : Bloomberg, Ostrum AM

Russia refused to adhere to the Saudi proposal causing an oil crash. WTI prices is down 30% towards a low at $31.

Russia's objective is to respond to US sanctions by putting pressure on US shale oil producers although the low-price strategy initiated by Riyadh in 2014 failed spectacularly. Financial pressure will cause defaults, a loss of market capitalization and restructuring but will signal the end of OPEC, which has lost its market power.

OPEC is no longer viable

The coronavirus crisis ignited a sharp fall in global oil demand. Oil-exporting countries have attempted to strike a deal to cut production. OPEC eyed cutting output 1mbpd on the condition that Russia and affiliated countries would reduce output by a further 500kbpd. Russia's decision not to participate to the effort to support oil prices caused a sharp downward adjustment in crude prices. Brent prices swiftly lost $15 to a low of $32 on Monday morning, the lowest level since 2016. The failure to coordinate output strategies emphasizes the fragility of the cartel, which no longer represents the marginal producer since the emergence of US shale oil. In fact, the US energy independence allowed the Trump administration to impose heavy sanctions on several countries including Russia without undergoing higher energy costs. The non-cooperative strategy of Russia may constrain US shale output or even weigh on Donald Trump's chances for reelection if Texas falls into recession for instance. The strategy appears risky. Russia's ability to withstand low crude prices is likely better than in 2014 but the drop in the ruble (74 against the US dollar) may trigger contraction in domestic demand. Saudi Arabia, engaged in regional conflicts, is in the midst of a succession war. The fiscal breakeven oil price stands at $83 for Saudi Arabia, or possibly slightly higher. The abandonment of the restrained supply strategy may have considerable negative consequences in the Kingdom and other producing countries notably in Sub-Saharan Africa.

Central Banks panic

The collapse in oil prices may have an ambiguous impact on the US economy. Oil production is close to 13mbpd despite much lower investment than in 2014. The productivity leap in the US oil-producing sector after the restructuring period of 2016 will likely repeat itself. Defaults are inevitable but restructuring will not alter production capacities in the long run. Furthermore, households will greatly benefit from lower energy costs. Estimates suggest the gain in purchasing power could fetch 125b per annum equivalent to 0.6pp of GDP. The historic fall in long-term interest rates already encouraged a wave of mortgage refinancing which will unleash resources to sustain consumption in months ahead provided that consumer confidence holds up. The Fed role in this context is pretty clear. The 50bp rate cut failed to rein in market volatility but other measures will likely be implemented. Eligible collateral to Fed repo transactions may be enlarged to private-sector bonds as was the case for the 2008 TALF scheme. The objective is to avoid a credit crunch if banks no longer have the balance sheet to extend credit. The reduction in Fed Funds rates to 0% could be decided very shortly. One cannot rule out the resumption of asset purchases. The extreme volatility backdrop in equity markets remains a reason to be long US Treasuries, at whichever yield levels. The yield on US Treasuries hit a 0.31% low during the Asian session. US yields are below 1% across the whole maturity spectrum. US growth is not the issue as evidenced by strong payrolls (+273k net jobs added in February) or the ISM services at 57.3. The Fed is effectively the US dollar central bank rather than the Central Bank of the US. Contraction in global trade linked to the virus outbreak will cause missed dollar payments. Activation of dollar FX swap lines between central banks could prove an effective line of defense against a dollar liquidity crunch in the rest of the world.

The ECB facing pressure to intervene

On the other side of the Atlantic, the ECB's room for maneuver appears quite limited. Christine Lagarde's press conference is this week's main event. The agenda of the strategic review has been changed by the virus outbreak. Coordination of monetary policies may require accepting a dearer euro. Rate cut would be a disaster for euro area banks but some measures must be taken to address financial market meltdown. The priority will be to assure liquidity conditions remain adequate for banks and firms to avoid that a liquidity crunch turns into a solvency crisis. In parallel, the APP share of corporate bond purchases is likely to rise. The scope of eligible collateral could be extended to include short-term paper issued by SMEs either within the existing TLTRO program or additional transactions. Bunds remain the safe haven reference all the more so that selling of peripheral bonds and corporate bonds is problematic amid illiquid markets.

US equity markets suspended

The downward spiral in US equity markets appears limitless. The Monday drawdown caused suspension in equity trading after a 7% drop shortly after market opening. Liquidation of long positioning continued as oil prices plummeted. Asset managers and leveraged funds had liquidated about one third of net long future positions as of March 3. The level of market capitulation is impossible to know exactly although it is the key to call a bottom in the stock market. As concerns credit markets, spreads on macro-hedging instruments including CDS indices have skyrocketed on March 9. The IG index is trading about 110bp. The iTraxx XO spread in turn hovers about 500bp. These spreads appear inconsistent with historic default risk but expected rating downgrades on the BBB cohort may continue to weigh on the high yield market.

Main Market Indicators

G4 Government Bonds	09-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-1 %	-18	-36	-40
EUR Bunds 10y	-0.86%	-23	-47	-67
EUR Bunds 2s10s	15 bp	-5	-11	-27
USD Treasuries 2y	0.38 %	-52	-102	-118
USD Treasuries 10y	0.51 %	-65	-107	-141
USD Treasuries 2s10s	13 bp	-14	-6	-22
GBP Gilt 10y	0.16 %	-25	-41	-66
JPY JGB 10y	-0.16 %	-5	-13	-15
€ Sovereign Spreads (10y)	09-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	47 bp	+15	+22	+17
Italy	228 bp	+52	+95	+68
Spain	112 bp	+21	+45	+47
Inflation Break-evens (10y)	09-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	38 bp	-26	-46	-
USD TIPS	100 bp	-46	-66	-79
GBP Gilt Index-Linked	283 bp	-19	-26	-29
EUR Credit Indices	09-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	128 bp	+14	+37	+35
EUR Agencies OAS	56 bp	+6	+14	+12
EUR Securitized - Covered OAS	50 bp	+7	+12	+9
EUR Pan-European High Yield OAS	465 bp	+46	+143	+161
EUR/USD CDS Indices 5y	09-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	105 bp	+38	+62	+61
iTraxx Crossover	467 bp	+161	+253	+261
CDX IG	115 bp	+48	+69	+69
CDX High Yield	554 bp	+182	+263	+274
Emerging Markets	09-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	402 bp	+29	+101	+111
Currencies	09-Mar-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.146	+2.68	+5.02	+2.04
GBP/USD	$1.312	+2.37	+1.59	-1.12
USD/JPY	¥102.14	+5.09	+7.39	+6.31
Commodity Futures	09-Mar-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$34.5	-$17.4	-$20.3	-$30.2
Gold	$1 677.0	$31.7	$100.5	$154.2
Equity Market Indices	09-Mar-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	2 770	-10.38	-16.77	-14.28
EuroStoxx 50	2 959	-11.37	-22.10	-20.99
CAC 40	4 708	-11.73	-21.92	-21.25
Nikkei 225	19 699	-7.71	-16.83	-16.73
Shanghai Composite	2 943	-0.93	1.83	-3.50
VIX - Implied Volatility Index	53.27	59.40	244.34	286.57

Source: Bloomberg, Ostrum Asset Management

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