Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

Document intended for professional clients

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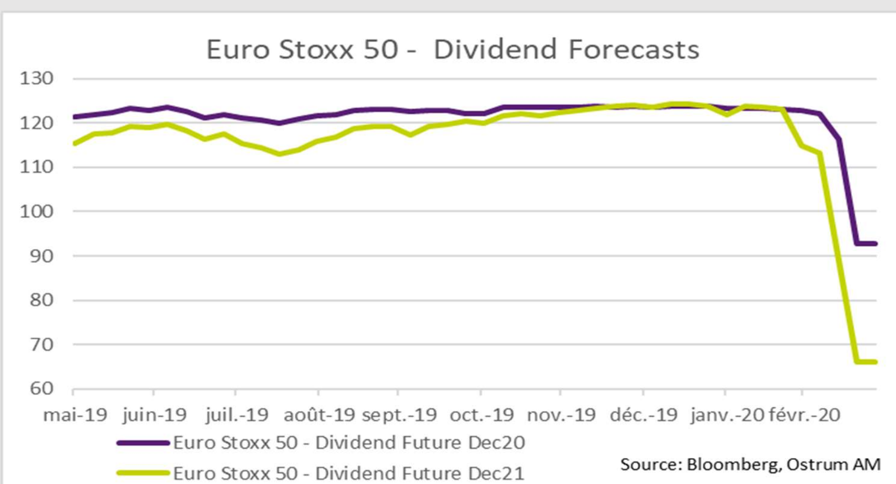
Time trial

Key Points

- **ECB launches PEPP – 750b purchases including commercial paper**
- **Greek bonds now eligible to ECB buying programme**
- **Fed forces yields lower, expands QE to credit and ETF shares**
- **Relief on sovereign spreads, persistent tensions on credit**

US equity markets tumbled last week hence erasing the late week bounce on the previous trading session (+9%). European markets were a touch less volatile last week losing about 1% across major benchmark indices. The dollar barely stabilized late last week. Excess demand for the greenback forces greater coordination of global central bank policies. The euro-dollar exchange rate hovers about $1.07. Bond markets remain extremely volatile despite continued intervention from the Fed, the ECB and the BoE, which cut rates to 0.1% and raised asset purchases by £200b..The yield on 10-year notes has declined below the 1% threshold (0.85%). <the steepening trend has hence reversed. Bund yields initially rose before falling back to a weekly close below -0.30%. Oil is as volatile as equity markets as the market has found a new equilibrium below $30. Liquidity hoarding implies large outflows from money market funds and significant upward pressure on short-term credit spreads. Conversely, insurers shop for long-term bonds. Spread curves hence flatten. Euro IG credit is trading about 230bp. Financials have underperformed the market.

Chart of the week



The virus crisis will impose drastic revisions to 2020 earnings in light of plunging sales.

Corporate guidance are doubtful at this juncture.

Dividend futures provide a gauge of the coming reduction in earnings. For 2020, total dividends to be paid by Euro Stoxx 50 will be cut by 20% et another similar drop is expected for next year.

Unprecedented recession

Confinement measures are being generalized across Europe and some states in the US including New York and California (which is the fifth economy in the World) have announced similar restrictions. Non-essential activities are being shut down. The economic scenario depends on the effectiveness of sanitary measures in the short run and the timing of the resumption of activity. Initial estimates are for a contraction in activity of around 20%qa in 2q20 in Europe and about15% in the US, where the epidemic started later. The swift recovery after 2-3 month of activity well below potential appears very optimistic. One must keep in mind that, in any recession, destruction of productive capital will reduce potential thereafter. Unemployment implies loss of worker's experience (i.e. a loss of human capital), which may affect workers' employability in the longer run even as activity growth picks up. Support measures which appear limitless precisely aim at avoiding bankruptcies linked to current emergency health policies. Government guarantees have been extended, for instance in France, to buy time but this strategy requires that the crisis does not last too long. The reality is that choices will have to be made. The consolidation of the air transportation sector appears inevitable even as aircraft manufacturers will be saved given the strategic nature of this activity and technologic know-how.

Risks induced by dollar scarcity

Furthermore, stress in US dollar funding markets globally represents a similar risk of disruption. The greenback plays a central role in commodity-exporting economies and countries producing intermediate goods integrated in the global supply chain or countries that are highly dependent on tourism and other foreign revenue sources (remittances). The dependence on global portfolio flows and the size of short-term dollar debt entail financial vulnerabilities. Australia is the developed country that appears most at risk. Malaysia, Indonesia and Thailand are also quite vulnerable. For this reason, the Fed lends dollars to several other central banks so that they are able to lend dollars to commercial banks in their jurisdiction in a bid to limit the negative impact from dollar shortage. The ECB will hence lent $100b, which helped to reduce tensions in FX swap markets. However, beyond 3 months' maturities, FX cross-currency swap margins remain abnormally elevated. Despite enhanced Central Bank policy coordination, excess demand pushed the dollar higher by 4 to 6% against a broad range of currencies last week.

The Fed's other objective may be to prevent dislocation at the long end of the curve after a sharp steepening movement. The $500b US Treasuries purchase plan will be spent very rapidly as the Fed accelerated buying to $50b a day late last week. Transactions are very transparent across all curve segments. As a comparison, during the last phase of QE, the Fed was buying $45b…. a month. US policymakers hence managed to force long-term bond yields down. Yields on 30y bonds have come down from over 1.80% to 1.42% at weekly close. Extreme volatility in long yields have led several market participants to opt for swap rate receiving positions. As concerns credit markets, the Fed is now authorized to purchase private debt and ETF shares in an effort to reduce discount to NAV of underlying assets.

ECB launches €750b PEPP

In the euro area, the ECB announced a new asset purchase programme (PEPP) worth €750b until at least the end of the year. The ECB expanded the scope of eligible assets to commercial paper. Total assets bought by the ECB in 2020 will top a trillion euros. The program will support activity and largely absorb all additional issuance linked to fiscal measures and other government guarantees in the euro area. Bund yields shot up to -0,15% at last week' high, before drifting lower breaching the -0.30% threshold at close which helped contain the weekly upturn in yields to some 22bp. Outflows from money market funds have had a non-negligible impact on Schatz yields, which crept higher above -0.70%. As concerns sovereign spreads, PEPP announcement initiated a sharp tightening in spreads, most notably in Italy. The 10-year BTP spread declined from a high at 320bp to roughly 200bp currently. Greek bonds now benefit from an ECB waiver which makes them eligible to the asset purchase program. As a result, the spread on Greece 2029 bond plunged from over 410bp to less than 300bp.

Conversely, European credit went through a difficult period as equity markets plunged. Spreads average 230bp over Bunds with significant underperformance from the financial sector. Credit indices have been traded in large volumes by multi-asset managers in the context of highly illiquid cash corporate bond markets. Short-term bond prices continue to be marked down, way below normal. In fact, commercial paper purchases included in the PEPP have not yet started and valuations keep drifting lower. The ECB will have to make sure that liquidity conditions have reverted to normal ahead of the March quarterly close. In addition, high yield is under intense pressure given expectations of widespread IG credit downgrades in the context of a sharp recession. Average high yield spreads stand near 900bp.

Main Market Indicators

G4 Government Bonds	23-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.67 %	+21	-4	-7
EUR Bunds 10y	-0.38%	+8	+5	-19
EUR Bunds 2s10s	30 bp	-13	+9	-12
USD Treasuries 2y	0.25 %	-11	-110	-132
USD Treasuries 10y	0.75 %	+3	-72	-117
USD Treasuries 2s10s	50 bp	+14	+38	+15
GBP Gilt 10y	0.42 %	-2	-15	-40
JPY JGB 10y	0.07 %	+5	+13	+8
€ Sovereign Spreads (10y)	23-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	49 bp	-14	+26	+18
Italy	196 bp	-67	+62	+36
Spain	113 bp	-17	+48	+48
Inflation Break-evens (10y)	23-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	2 bp	-21	-76	-
USD TIPS	76 bp	+3	-86	-103
GBP Gilt Index-Linked	272 bp	-10	-35	-39
EUR Credit Indices	23-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	236 bp	+54	+147	+143
EUR Agencies OAS	73 bp	+1	+33	+29
EUR Securitized - Covered OAS	55 bp	-5	+19	+14
EUR Pan-European High Yield OAS	889 bp	+223	+584	+585
EUR/USD CDS Indices 5y	23-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	117 bp	-3	+69	+73
iTraxx Crossover	703 bp	+91	+462	+497
CDX IG	131 bp	+8	+79	+86
CDX High Yield	864 bp	+208	+538	+584
Emerging Markets	23-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	673 bp	+149	+368	+383
Currencies	23-Mar-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.073	-3.81	-1.26	-4.41
GBP/USD	$1.147	-6.25	-11.35	-13.53
USD/JPY	¥111.58	-5.04	-1.08	-2.69
Commodity Futures	23-Mar-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$25.6	-$4.5	-$32.4	-$39.1
Gold	$1 543.4	$51.1	-$131.1	$20.6
Equity Market Indices	23-Mar-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	2 208	-7.45	-33.83	-31.64
EuroStoxx 50	2 475	1.02	-34.87	-33.91
CAC 40	3 902	0.52	-35.29	-34.73
Nikkei 225	16 888	-3.12	-28.07	-28.61
Shanghai Composite	2 660	-4.63	-12.48	-12.78
VIX - Implied Volatility Index	66.57	-19.49	289.75	383.09

Source: Bloomberg, Ostrum Asset Management

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