STRATEGY WEEKLY

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Fed expands toolkit… again

Key Points

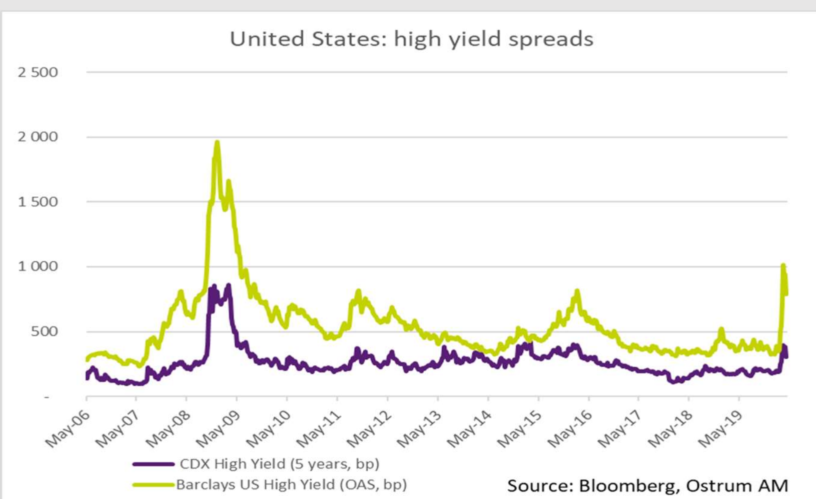
- **S&P gained 10% last week**
- **Fed to buy fallen angels' bonds**
- **Credit spreads tighten, including high yield**
- **Dollar weakens slightly**

Fed intervention seems limitless. Risky asset markets were supported by the Fed's decision to purchase high yield bonds I addition to other programs targeting the real economy. The S&P had its best week since 1974 (+10.4%) ahead of the Easter break.

Treasury yields crept higher towards 0.75% as the yield curve steepened. Euro area yields followed up on the upside though more modestly although the bond yield movement was more pronounced (+12bp last week). Italian bond auctions commended a temporary discount ahead of auctions before markets bounced. Ten-year BTP spreads stand below 200bp.

Credit was the main beneficiary of the Fed's decision, especially its high yield segment. Investment grade spreads have shrunk by 29bp in Europe and by as much as 46bp in the US. High yield tightening reached 109bp on CDX HY. Easing tensions on the dollar is clearly supportive for risky assets. The euro rose towards $1.10. Emerging debt also participated to the rally despite heavy IG bond supply early on last week.

Chart of the week



The Fed's decision to change eligibility criteria of corporate bonds sparked a sharp rally in high yield. Synthetic spreads (CDX) narrowed by more than 100bp last week as high yield bond spreads dipped below 800bp.

Direct support to fallen angels down to BB- will limit forced selling by institutional investors facing rating constraints and bond funds tracking benchmark indices. That said, the Fed, which expanded SPV investments into credit, now assumes even more risk that could weigh on the dollar in the longer run.

A rally engineered by OPEC+ and the Fed

The 10%+ rally in the S&P 500 equity gauge during the Good Friday shortened week appears traceable to OPEC+ discussions regarding oil output and further monetary expansion in the United States.

As regards oil, OPEC enlarged to Russia managed to secure a deal to reduce oil output with Mexico and the US participating. Daily productions of Saudi Arabia and Russia will be cut to 8.5mbpd. Cutbacks in output may not be sufficient to match the fall in world demand worth 25 to 35mbpd in April. The lack of available storage capacity may further weigh on prices. As concerns the US, strategi reserves amount to 643mn barrels compared to 713mn barrel storage capacity. A fallback in prices is hence likely, despite massive floating storage activity. WTI prices hence closed last week below $23.

Fed expands toolkit to include high yield purchases

In parallel, the Fed is assuming even more financial risks. Available amounts now total $2.3T in additional to unlimited support committed to Treasury and MBS markets. In coordination to the Treasury's CARES Act announced recently, the US Central Bank will fund a Paycheck Protection Progam worth $300b. Hence the Fed will lend to banks against SME loans taken as collateral (without haircut). Furthermore, the Main Street Lending Program has $600b firepower to make loans to SMEs via an SPV supported by $75b equity investment by the Treasury. Furthermore, $500b will be channeled to municipals and local governments. The credit market (PMCCF, SMCCF) and securitization facilities have been expanded to $750b and $100b respectively. As concerns credit, the Fed can now purchase bonds issued by fallen angles, corporations that have lost their investment grade rating since March 22, as long as their retain a rating above BB-. The Fed will also expand its support to exchange-traded funds invested in high yield corporate bonds. TALF will offer $100b worth of non-recourse 3-year loans to issuers of asset-backed securities, including CLO AAA tranches.

It is probably too early to fully grasp the consequences of expanded monetary easing. The size of the balance sheet and the risks assumed by the Fed may weigh on the dollar. Excess dollar supply may soon emerge making the greenback the World's funding currency of choice mimicking the USD carry trade of 2009. Such market backdrop would be supportive of risky asset markets.

A fragile rebound

Market optimism is resting on yet another round of Fed monetary stimulus and hope for an orderly return to growth after the sanitary crisis is over. However, economic data releases will continue to be catastrophic for several months. Initial jobless claims topped the 6.6mn mark last week which may be indicative of unemployment rate bursting beyond 20% in the near future. The reality of a plunge in profitability could jeopardize the current 20% equity rally from the March 23 low. Corporate earnings releases will likely reveal sharp contractions in quarterly profits. Government support is conditioned to giving up equity buyback programs, which could wipe out a significant share of $700-800 annual purchases observed in the past few years. Around 70% of banks will cut dividends. Recent sector performance trends favor sectors that are most exposed to the virus outbreak including automobile, commodities and leisure. This does hint at caution amid evidence of significant short covering. In Europe, the sector performance backdrop has been similar. Valuations have adjusted to widespread dividend cut announcements across sectors including utilities and banks. According to dividend future markets, dividends will not rejoin their 2019 level for several years.

In bond markets, yields have adjusted to rising equity prices. T-note yields rose to a 0.75% high last week. Daily Fed Treasury purchases has been reduced somewhat since the start of April. The slowdown in Treasury bond purchases could hint at yield targeting in the months ahead. In the euro area, Bund yields peaked near -30%. Sovereign spreads remain sensitive to primary market activity. BTP spreads deteriorated ahead of bond auctions before the closing the trading week under the 200bp mark on 10-year maturities. Spread volatility has diminished. Spain now trades around 115bp whilst Portugal Bonos hover about 130bp.

Credit spreads have eased following the Fed's communiqué. IG credit spreads have shrunk to 223bp against US Treasuries, a 46bp decline from a week ago. The real surprise pertains to high yield, which is now eligible to Fed purchases. Spreads have swiftly narrowed by more than 100bp on synthetic CDX indices. Speculative credit bond spreads trade within 800bp, despite continued uncertainty particularly in the shale oil sector. European credit markets benefitted from the rally in US credit. The scope for additional spread narrowing is substantial which may foster investment flows into credit funds going forward. Financial bonds outperformed whilst cyclical sectors and utilities bonds partly retraced prior gains.

Emerging bonds performed better thanks to a weaker dollar. Despite heavy supply from investment-grade sovereign issuers, weekly EMBI spread narrowing amounted to 41bp.

Main Market Indicators

G4 Government Bonds	13-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.62 %	+4	+34	-2
EUR Bunds 10y	-0.35%	+9	+44	-16
EUR Bunds 2s10s	27 bp	+5	+11	-14
USD Treasuries 2y	0.22 %	-4	-27	-135
USD Treasuries 10y	0.72 %	+5	-24	-120
USD Treasuries 2s10s	50 bp	+9	+3	+15
GBP Gilt 10y	0.31 %	-1	+7	-52
JPY JGB 10y	0.02 %	+0	-3	+3
€ Sovereign Spreads (10y)	13-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	45 bp	-4	-11	+15
Italy	194 bp	+2	-39	+34
Spain	113 bp	-2	-4	+48
Inflation Break-evens (10y)	13-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	36 bp	+7	-2	-
USD TIPS	123 bp	+7	+31	-56
GBP Gilt Index-Linked	287 bp	-1	-1	-24
EUR Credit Indices	13-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	209 bp	-29	+51	+116
EUR Agencies OAS	72 bp	-2	+3	+28
EUR Securitized - Covered OAS	64 bp	+1	+2	+22
EUR Pan-European High Yield OAS	698 bp	-94	+139	+394
EUR/USD CDS Indices 5y	13-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	80 bp	-24	-30	+36
iTraxx Crossover	463 bp	-126	-66	+257
CDX IG	82 bp	-37	-38	+37
CDX High Yield	524 bp	-185	-88	+244
Emerging Markets	13-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	607 bp	-41	+136	+317
Currencies	13-Apr-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.091	+1.02	-1.76	-2.82
GBP/USD	$1.249	+1.51	+1.74	-5.81
USD/JPY	¥108.05	+0.9	-0.4	+0.49
Commodity Futures	13-Apr-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$31.3	-$2.8	-$4.1	-$32.8
Gold	$1 690.5	$38.2	$160.7	$167.7
Equity Market Indices	13-Apr-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	2 790	10.40	-3.21	-13.65
EuroStoxx 50	2 893	7.60	-0.59	-22.76
CAC 40	4 507	6.77	-2.80	-24.61
Nikkei 225	19 043	2.51	9.25	-19.50
Shanghai Composite	2 783	0.69	-3.61	-8.76
VIX - Implied Volatility Index	44.56	-4.79	-5.79	223.37

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