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May could be a turning point

Key Points

- **Sharp contraction of US and European economies in 1Q20**
- **ECB cuts interest rates on long-term operations**
- **Bund close to -0,60%**
- **Fitch lowers Italy's rating to BBB-**

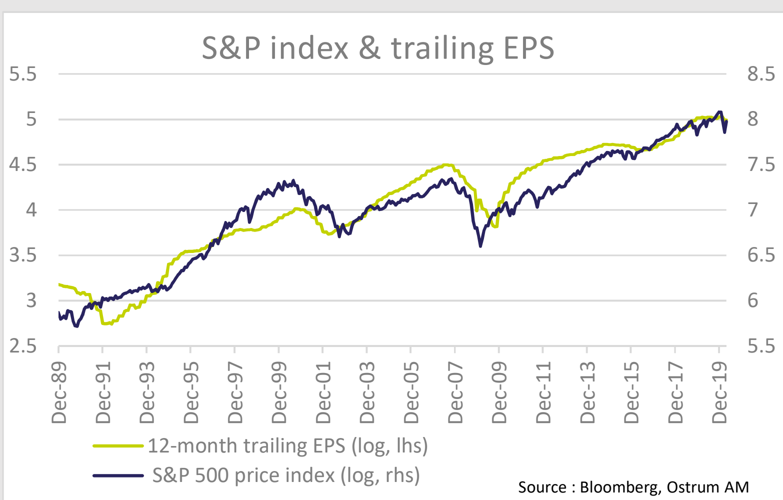
The May 1 trading session saw a near 3% drop in the S&P 500 erasing all weekly gains. The energy sector remains challenged by WTI prices below $20. The weekly rise in European indices (4%) hints at profit taking early on this week. The bounce in banking and cyclical stocks remain quite fragile.

The ECB just raised its monetary support on long-term lending operations. Ten-year Bund yields sled towards -0.60%. The T-note yield is however trading sideways as the Fed kept its policy unchanged.

Peripheral bonds remain volatile but rather well oriented. The front-loaded downgrade of Italy by Fitch (BBB- stable) came as a surprise. Italy bonds underperformed other euro area peripheral markets. Euro IG bonds tighten as investors continue to raise credit exposure. European high yield also outperform.

In foreign exchange markets, the dollar was down last week. The euro crept higher towards a $1.097 weekly close. Gold is trading about $1700.

Chart of the week



The stock price rebound since March 23 appears to foreshadow a swift upturn in corporate earnings. The current drop in profits is being ignored as markets seemingly look through the EPS valley.

During the 1990 recession, stock prices increased even as EPS declined through 1991. IN 2009, the market bounced 8 months prior to the low point in earnings.

Markets should always discount future earnings but uncertainty surrounding the 2020 recession require an additional risk premium.

Sharp contraction in the economy

Health measures have had a considerable economic cost. Activity collapsed in the first quarter according to advance estimates.

In the US, the Bureau of Economic Analysis estimated that output fell by 4.8%qa between January and March. Household consumption plunged by 7.6%qa with unheard-of decline in service spending (-10.1%qa). The service sector is greatly impacted by social distancing measures. The fall in consumer spending on durable goods is more common in recessionary episodes. The rapid deterioration in labor market conditions likely amplified the trend to delay spending decisions (-16.1%qa). Indeed, unemployment rate is already about 16% in April. Investment unsurprisingly weakened despite the 21%qa increased in residential investment. That said, Homebuilders confidence plummeted in April which is indicative of contraction in housing investment over the coming months. Public expenditure provided little support adding just 0.7pp to 1q20 GDP. Net external demand contributed positively although the improvement is traceable to a sharp decline in imports whilst inventory building subtracted 0.5pp from GDP.

In Europe, confinement measures implemented early have pushed the economy into recession. Euro area GDP contracted by 3.8%q in the first quarter. In France, output loss was 5.8%q. The magnitude of the decline in activity turned out to be much larger than initial INSEE estimates of 3pp loss per month of confinement. In just two weeks' time, the plunge in activity was indeed four times as fast as predicted. Spain contracted at a 5.2%t clip in 1q20. Economic recession will intensify in the second quarter. Preliminary surveys in services already stand at all-time lows.

The ECB eases policy again

The European Central Bank has not yet enhanced its asset purchase envelope. There is however no doubt that the ECB will end up raising the amount of asset purchases as public borrowing soars. For now, the Bank focuses on liquidity measures by lowering interest rates by 25bp on TLTRO-III transactions (to as low as -1%). Furthermore, 7 new refinancing operations (PELTROs) maturing in September 2021 have been announced; the list of eligible collateral has been extended to include bonds that have lost IG rating since April 7. In the US, the Fed maintained its policy unchanged. Daily Fed purchases of US treasuries and MBS slowed in April. It is possible that the Fed may shift to long-term yield targeting policy in a bid to limit its holdings of debt securities and make balance sheet room for additions facilities focused on credit, loans and municipals financing. Yield targeting policies are already pursued by the BoJ (10-year JGB target of 0%) and the RBA (3-year yield target at 0.25%).

S&P plunged late last week

Despite monetary support, equity markets ended last week of trading on a negative note. The S&P 500 index was down 2.9% last Friday erasing all of last week's gains. Sector performances showed a dip in energy stocks as excess supply keeps weighing on oil prices. Discretionary consumption also underperformed. As regards S&P 500 companies, with 279 earnings releases so far, earnings growth was a negative 8.7% in the first quarter. Utilities (+7%), consumer goods (+5.7%), healthcare (+5.3%) and technology (+3.7%) however reported earnings growth.

The US weekly close was not reflected in European markets. The price rebound in sectors that are most exposed to the consequences of the pandemic continued last week. Profit taking is likely in the coming days. The earnings season started in the euro area (125 publications out of 279 stocks in the Euro Stoxx). Average earnings growth is below the -30% mark as sales fell 6%. Utilities and telecommunication services resisted the crisis. Corporate earnings linked to commodities fell anywhere between 30 and 50% in the first quarter. Automobile (-80%) underwent a considerable decline in earnings.

Bund yields through the -0.50% threshold

By focusing primarily on liquidity measures instead of asset purchase programs, the ECB surprised market participants. The ECB will lend at interest rates as low as -1%, which will allow banks to implement carry trades in core sovereign bond markets. The yield on 10-year Bunds is now close to -0.60%. Reach for yield sparked renewed flattening pressure on 2s10s which dipped below 20bp. A broad consensus of investors expected a rise in asset purchases. The surprise did not prevent tightening in Spanish and Portuguese spreads. Conversely, Fitch's decision to downgrade Italy triggered a volatility spurt in BTP markets. The ratings agency lowered the sovereign rating to BBB-. On 10-year maturities, the BTP spread was modestly up last week (+4pb).

In parallel, spread narrowing continues in credit space. Credit fund inflows have been observed over the past 5 weeks. Cumulated inflows have however not yet fully erased March outflows. The average spread on euro investment grade is now 186bp against Bunds (-8bp over five trading days). In turn European high yield also outperformed risk-free Bunds (-14bp). High yield inflows are also improving significantly of late.

Main Market Indicators

G4 Government Bonds	04-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.74 %	-8	-8	-14
EUR Bunds 10y	-0.55%	-9	-11	-36
EUR Bunds 2s10s	20 bp	-1	-2	-22
USD Treasuries 2y	0.19 %	-3	-4	-138
USD Treasuries 10y	0.63 %	-3	+4	-129
USD Treasuries 2s10s	44 bp	+0	+8	+9
GBP Gilt 10y	0.24 %	-6	-7	-58
JPY JGB 10y	-0.02 %	+2	-1	-1
€ Sovereign Spreads (10y)	**04-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	50 bp	+3	-1	+20
Italy	233 bp	+11	+33	+73
Spain	133 bp	-1	+15	+68
Inflation Break-evens (10y)	**04-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	32 bp	+2	+4	-
USD TIPS	109 bp	-7	+0	-69
GBP Gilt Index-Linked	275 bp	+5	-14	-37
EUR Credit Indices	**04-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	186 bp	-8	-53	+93
EUR Agencies OAS	72 bp	-3	-2	+28
EUR Securitized - Covered OAS	67 bp	-2	+4	+26
EUR Pan-European High Yield OAS	658 bp	-14	-137	+354
EUR/USD CDS Indices 5y	**04-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	86 bp	+5	-18	+42
iTraxx Crossover	519 bp	+26	-70	+313
CDX IG	91 bp	-1	-28	+46
CDX High Yield	659 bp	+3	-50	+379
Emerging Markets	**04-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	608 bp	-31	-41	+317
Currencies	**04-May-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.093	+0.98	+1.16	-2.69
GBP/USD	$1.243	+0.19	+0.98	-6.31
USD/JPY	¥106.87	+0.39	+2.01	+1.6
Commodity Futures	**04-May-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$26.1	$3.0	-$9.4	-$37.4
Gold	$1 704.0	-$8.4	$51.7	$181.2
Equity Market Indices	**04-May-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	2 831	-0.21	13.74	-12.38
EuroStoxx 50	2 812	-2.42	5.61	-24.91
CAC 40	4 376	-0.40	4.00	-26.80
Nikkei 225	19 619	0.98	10.10	-17.07
Shanghai Composite	2 860	0.76	4.59	-6.23
VIX - Implied Volatility Index	39.35	18.20	-15.92	185.56

Source: Bloomberg, Ostrum Asset Management

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