Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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European policy mix supports markets

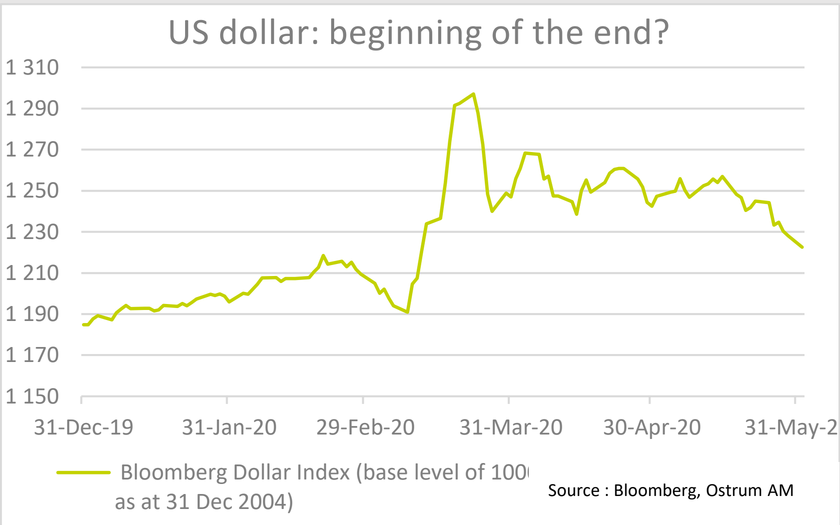
Key Points

- **The European commission proposes a recovery plan worth €750b**
- **ECB may raise the PEPP amount**
- **Credit rally accelerates**
- **Dollar slowly depreciating**

Equity markets remain upbeat thanks to the European Commission proposal of €750b recovery plan which draws along the same lines as the French-German initiative of a week ago. European equities gained 5% last week with cyclical stocks and banks leading the charge. Bund yields crept higher touching -0.40%. Sovereign spreads tightened considerably. Indeed, 10-year BTP spreads have broken below the 190bp mark. The risk-on phase benefits corporate credit markets as spreads shrink by a further 20bp over the past week.

Dollar weakness, despite a downward adjustment in the CNY, responds to lower risk aversion. Gold, a substitute store of value, continues to rise beyond the $1730 mark. The sharp acceleration in the Fed's corporate bond purchases added fuel to the credit rally. In turn, emerging bonds tightened below 520bp against US Treasuries.

Chart of the week



The synthetic dollar index has been falling since mid-May. The knee-jerk reaction that favored the US dollar at the climax of the equity drawdown is March (USD index peaked on March 23rd) is being unwound as the Fed's balance sheet expands above $7T$.

USD swaps with foreign central banks have contributed to assuage dollar scarcity in the rest of the World.

The dollar may have become the World's funding currency again, as in 2009, when Fed easing had sparked a sharp rally in stock markets.

China will not be the only subject of the Presidential elections

Relations between China and the US have worsened after Beijing's decision to impose a security law in Hongkong. After having argued that the US could revoke Hongkong status, it appears that measures envisaged by Donald Trump may not reignite the trade war. Relief was perceptible across financial markets on Friday late in the session. That said, China suspended agricultural product imports from the US. The domestic political situation is quite worrying just months before the US presidential election. Riots which have been observed across the country entail a stark reminder that race issues remain very prevalent in US society all the more as the economic crisis will further increase inequalities.

The European Commission proposes a €750b recovery plan

Transition to a green economy and digital transformation are top priorities of the fund along with spending to ensure cohesion across territories and financing of strategic industries. These investments will be added to the 2021-2027 European budget. Like in the French-German proposal, the EU will issue debt guaranteed by member states with repayment spread over the 2028-2058 period. The financing of the plan will be assured by a gradual increase in member country contributions and the installment of European-level tax (tax on digital economy, multinationals or carbon…). Unanimity among EU member states is required to adopt the plan. It is quite unlikely that an agreement will be reached by the next EU summit in June but it is obvious that the Covid crisis is profoundly changing the conduct of economic policy in Europe. In parallel, France announced a €8b plan to support the automotive sector. Germany may unveil this week a recovery package worth nearly €80b including transfers to households, SMEs, local governments and subsidies to the auto sector.

Euro area stock markets have reacted favorably to unprecedented support proposed by the Commission. The Euro Stoxx 50 posted a 5% gain last week despite profit-taking on Friday amid heightened tensions between China and the US. The rebound in cyclical sectors and bank stocks gained traction in May. The market keeps ignoring the plunge in profitability expected in the second quarter. The gap between optimism shown by financial analysts (ZEW survey) and low confidence among German purchasing managers (IFO) is unprecedented. The continuation o the rally likely results from widespread short positioning as is the case on S&P future markets. The performance of the US market is a key input to European stock returns. Short covering indeed causes prices to gap higher regularly. In parallel, the recovery in small cap stocks and value is taking hold in the US. We suspect the same trend is developing across European markets.

ECB to expand PEPP

Monetary policy also plays a great role in this market environment that favors risk-taking. European financing needs will require a top-up to the 750b PEPP program. A consensus is developing in favor of an increase in purchases by €250 to €500b. The ECB will remain the marginal buyer of public-sector bonds to the tune of €40b per week. The June TLTRO-III will add at least €700b liquidity. Banks will use ECB loans to fund carry trades on sovereign bonds with maturities around 3 years. The unheard-of European solidarity contributed to spread tightening in Italy below 200bp and Spain and Portugal under the 100bp threshold. The 20-year OAT syndication attracted significant demand. Swap spreads narrowed by 4-5bp last week in the wake of the sovereign rally. Conversely, 10-year Bunds moved slightly higher towards -0.40%. Fiscal stimulus packages and the uptrend in risky assets are unsupportive for German bonds.

In US bond markets, steepening remains the trend. The 5s30s spread rose beyond 110bp. A yield curve control policy with targets on 5- or 10-year note yields may supplement the Fed's strategy in the months to come. This will allow investors to express their views on the backend of the yield curve (30y at 1.45%; +9bp over 5 sessions). Speculative accounts continue to short Treasuries. Credit spreads keep narrowing. US IG is now trading at 174bp over Treasuries (-12bp in five days) despite unprecedented bond issuance since March. Final buying flows keep accumulating. Corporate bond purchases of the Fed have really started last week and now total $34b. High yield benefits from the credit rally (-43bp).

The dollar as a risk aversion barometer

The dollar depreciated markedly despite a downward adjustment in the Chinese Renminbi allowed by the People Bank of China. Indeed, the European recovery plan sparked renewed interest in the euro which is now trading above $1.11.

Main Market Indicators

G4 Government Bonds	01-Jun-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.65 %	+3	+11	-5
EUR Bunds 10y	-0.40%	+9	+18	-22
EUR Bunds 2s10s	25 bp	+7	+8	-17
USD Treasuries 2y	0.16 %	-1	-3	-141
USD Treasuries 10y	0.66 %	+0	+5	-126
USD Treasuries 2s10s	50 bp	+1	+8	+16
GBP Gilt 10y	0.23 %	+6	-2	-59
JPY JGB 10y	0.01 %	+1	+3	+3
€ Sovereign Spreads (10y)	**01-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	38 bp	-7	-10	+7
Italy	189 bp	-18	-46	+29
Spain	98 bp	-13	-33	+33
Inflation Break-evens (10y)	**01-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	42 bp	+9	+7	-
USD TIPS	118 bp	+7	+11	-61
GBP Gilt Index-Linked	294 bp	+7	+20	-17
EUR Credit Indices	**01-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	166 bp	-20	-20	+73
EUR Agencies OAS	60 bp	-6	-12	+16
EUR Securitized - Covered OAS	47 bp	-6	-20	+6
EUR Pan-European High Yield OAS	567 bp	-70	-91	+263
EUR/USD CDS Indices 5y	**01-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	71 bp	-9	-12	+27
iTraxx Crossover	416 bp	-64	-85	+209
CDX IG	79 bp	-9	-11	+34
CDX High Yield	516 bp	-102	-137	+236
Emerging Markets	**01-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	515 bp	-16	-114	+225
Currencies	**01-Jun-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.113	+1.41	+2.12	-0.87
GBP/USD	$1.250	+1.35	+0.56	-5.74
USD/JPY	¥107.59	-0.02	-0.71	+0.92
Commodity Futures	**01-Jun-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$38.7	$2.5	$10.6	-$24.3
Gold	$1 739.0	$26.6	$32.6	$216.2
Equity Market Indices	**01-Jun-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 057	3.44	8.00	-5.37
EuroStoxx 50	3 078	3.59	5.12	-17.82
CAC 40	4 763	4.91	4.17	-20.33
Nikkei 225	22 062	6.37	12.45	-6.74
Shanghai Composite	2 915	3.46	1.94	-4.42
VIX - Implied Volatility Index	28.27	0.39	-23.98	105.15

Source: Bloomberg, Ostrum Asset Management

Writing

AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

Legal information

www.ostrum.com

Ostrum Asset Management
Asset management company regulated by AMF under n° GP-18000014 – Limited company with a share capital of 27 772 359 euros
Trade register n°525 192 753 Paris – VAT: FR 93 525 192 753 – Registered Office: 43, avenue Pierre Mendès-France, 75013 Paris – www.ostrum.com
Tél. : 01 58 19 09 80

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