

# STRATEGY WEEKLY

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## Fed faced with unprecedented uncertainty

### Key Points

- Fed funds rates at zero through 2022
- Equity markets plunge: -6% in Europe
- T-note yields revert to 0.70%
- Spreads widen, especially in high yield

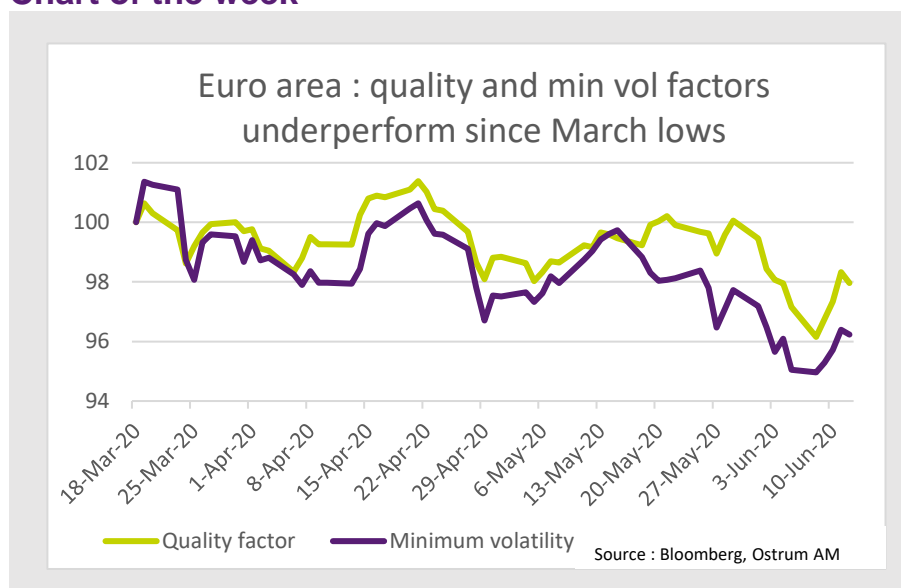
Fed pessimism and second wave fears sent equity markets lower with a nearly 6% drop in the S&P 500 index last Thursday. The drawdown in equities reminded investors of the fragility of the rally dominated by cyclical value stocks. European indices lost 6% for the whole week. In the US, the 2-year standstill in Fed Funds rates and ongoing QE purchases pushed yields down towards 0.70%. Bunds richened by 15bp. Sovereign bond spreads have logically retraced part of their earlier tightening.

Despite strong demand for sovereign issuance, peripheral bonds widened by around 20bp last week.

Credit continued to attract final investor flows but reacted to increased risk aversion. High yield also proved sensitive to the pullback in equities.

The dollar rise also triggers portfolio realignments. The yen was the only currency to gain vs. the US dollar. The euro nevertheless manage to remain above the \$1.12 threshold.

### Chart of the week



The rebound in stock prices in the euro area entails 32% gains from the 2020 low. The rally has been driven by discounted cyclical stocks (including automobiles, transport and industrials).

The quality factor showed a rare underperformance. These companies generally defined as high RoE, limited leverage and earnings resilience through the economic cycle. In turn, minimum volatility stocks posted 4% underperformance in the equity rally.

## Fed Funds rates unchanged until 2022

S&P plunged by nearly 6% last Thursday. The drawdown erased all June gains. The trigger for the fall in stock prices was the outcome of the FOMC meeting. The Fed's statement is almost identical to the April communiqué, but the summary of economic projections highlights unprecedented uncertainty about economic activity in the US. Growth forecasts from individual FOMC participants range from -1% to +7% for next year after a 6.5% contraction by 4q20. Unsurprisingly, Jerome Powell ruled out Fed Funds rate increases over a two-year horizon. Asset purchases will continue at the current pace. The Fed made it clear that it intended to buy \$80b worth of Treasuries and \$40b MBS each month. Over the next few weeks, the Fed's balance sheet will continue to be used extensively to provide credit to the economy. Credit facilities aimed at municipalities (\$16b used so far) and small-and-medium-sized businesses (Main Street Lending Facility \$31b so far) will continue to be deployed. The issue is that the Fed's balance sheet is overblown at \$7.2 and the Central Bank will have no choice but to fund the next stimulus package out of Washington. Hence a yield curve control policy (i.e. yield targeting) may not be implemented as long as uncertainty lingers regarding future federal government borrowing needs. Then the Fed will be able to dial down Treasury bond purchases. Foreign demand for Treasuries has declined since the start of the year. Oil-producing countries and lately Japanese institutions have massively sold US Treasury bonds in 2020. Hence keeping long-term rates under control still require Fed intervention all the more so that the Treasury has significantly increased long-term borrowing.

The other reason of the pullback in markets is the sanitary crisis. The epidemic is not yet under control in the US, Brazil and even China where lockdown measures have resumed in parts of Beijing. Fiscal stimulus will not be efficient if the sanitary crisis postpones the return to 'normalcy'. The Covid crisis also imposes structural changes in the economy given the nature of supply and demand shocks affecting the various sectors of the economy. Flexibility will be key to avoid a durable decline in potential output.

## Brutal downswing in equities

The plunge in equities is evidence of the extreme fragility of an equity rebound inspired by Central Bank liquidity and driven by cyclical stocks that are most affected by the Covid crisis. On the NYSE, the most shorted high beta stocks have considerably outperformed the market since the low point. Balance sheet quality and earnings visibility have not led to outperformance in spite of unheard-of economic uncertainty. During the confinement period, individual

investor participation has surged contributing to a sharp rise in trading volumes on beaten-down stocks since the start of the equity rally in March. The sustainability of the rebound appears questionable ahead of the 2q20 earnings season starting in mid-July. Beyond corporate earnings figures, corporate guidance will be of the utmost importance and may set tone for the rest of the year. European stock markets remain highly dependent on the outlook for US equities despite a notable improvement in investor sentiment towards the euro area. The euro's resilience through the latest bout of equity volatility is indeed reassuring. An agreement on the EU recovery plan must still be formally adopted. Failure to do so whilst Brexit deadlines are looming would likely send markets and the economy down again. In fact, banks and cyclical stocks (including automobiles and industry) lost 10% last week. Energy stocks could not escape lower oil prices.

## Large bounce in T-note and Bund prices

The upward trend in bond yields came to a halt as equity markets nosedived. The yield on T-note reverted to its previous equilibrium of about 0.70% late last week. Steepening pressure in the US will nevertheless endure. Despite the favorable market backdrop, the 30-year bond auction unveiled some fragilities. Final investor demand indeed diminished from a month ago. This week's 20-year bond deal may further weigh on 10s30s. In the euro area, Bunds appreciated by more than 15bp to break below the -0.40% mark. The 6b syndication of 30-year Bund drew demand in excess of €50b last week. Spain also borrowed through syndication of a 20-year Bonos (12b issued) which drew €80b worth of investor interests. Most Treasury departments use syndications to borrow more in one transaction and make securities quickly available for recent enhanced ECB buying programs (PEPP was just raised by €600b). After the recent success of the BTP Italia deal, Italy will tap household savings again with the launch of a BTP Futura bond in July. The new security, if held to maturity, will pay a premium linked to Italian nominal GDP. The risk aversion bout nevertheless pushed spreads wider by around 20bp across peripheral markets.

Credit markets also took a hit from the equity market fall. European IG credit spreads widened by 14bp with underperformance of financial debt securities in the wake of lower bank stock prices. High yield widened by 37bp. CDS indices recorded widening movements to the tune of 57bp on iTraxx Crossover and more than 80bp on CDX high yield. Profit taking was observed in IG space although credit fund inflows remain healthy and Central Bank purchases continue. The Fed has bought \$37b corporate bonds so far. Lastly, the rebound in the dollar took a toll on emerging bond spreads which were up some 22bp.

## Main Market Indicators

<b>G4 Government Bonds</b>	<b>15-Jun-20</b>	<b>-1wk (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR Bunds 2y	-0.67 %	-6	+5	-7
EUR Bunds 10y	-0.46%	-14	+7	-27
<b>EUR Bunds 2s10s</b>	<b>22 bp</b>	<b>-9</b>	<b>+2</b>	<b>-20</b>
USD Treasuries 2y	0.19 %	-4	+4	-138
USD Treasuries 10y	0.67 %	-21	+2	-125
<b>USD Treasuries 2s10s</b>	<b>48 bp</b>	<b>-17</b>	<b>-2</b>	<b>+13</b>
GBP Gilt 10y	0.19 %	-15	-4	-63
JPY JGB 10y	0.01 %	-4	+1	+2
<b>€ Sovereign Spreads (10y)</b>	<b>15-Jun-20</b>	<b>-1wk (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
France	40 bp	+4	-10	+10
Italy	189 bp	+17	-51	+29
Spain	100 bp	+14	-29	+35
<b>Inflation Break-evens (10y)</b>	<b>15-Jun-20</b>	<b>-1wk (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR OATi (9y)	44 bp	-7	+20	-
USD TIPS	118 bp	-10	+9	-61
GBP Gilt Index-Linked	284 bp	-9	+1	-28
<b>EUR Credit Indices</b>	<b>15-Jun-20</b>	<b>-1wk (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR Corporate Credit OAS	146 bp	+14	-46	+53
EUR Agencies OAS	57 bp	+6	-15	+13
EUR Securitized - Covered OAS	46 bp	+4	-16	+4
EUR Pan-European High Yield OAS	533 bp	+37	-128	+229
<b>EUR/USD CDS Indices 5y</b>	<b>15-Jun-20</b>	<b>-1wk (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
iTraxx IG	71 bp	+10	-20	+27
iTraxx Crossover	408 bp	+67	-133	+201
CDX IG	81 bp	+14	-15	+36
CDX High Yield	509 bp	+66	-178	+229
<b>Emerging Markets</b>	<b>15-Jun-20</b>	<b>-1wk (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
JPM EMBI Global Div. Spread	482 bp	+22	-89	+191
<b>Currencies</b>	<b>15-Jun-20</b>	<b>-1wk (%)</b>	<b>-1m (%)</b>	<b>YTD (%)</b>
EUR/USD	\$1.125	-0.37	+3.96	+0.18
GBP/USD	\$1.254	-1.27	+3.47	-5.47
USD/JPY	¥107.39	+0.82	-0.31	+1.11
<b>Commodity Futures</b>	<b>15-Jun-20</b>	<b>-1wk (\$)</b>	<b>-1m (\$)</b>	<b>YTD (\$)</b>
Crude Brent	\$37.9	-\$2.9	\$5.1	-\$25.0
Gold	\$1 708.6	\$11.1	-\$35.1	\$185.8
<b>Equity Market Indices</b>	<b>15-Jun-20</b>	<b>-1wk (%)</b>	<b>-1m (%)</b>	<b>YTD (%)</b>
S&P 500	3 041	-4.78	6.20	-5.86
EuroStoxx 50	3 113	-7.54	12.34	-16.89
CAC 40	4 789	-7.46	11.96	-19.89
Nikkei 225	21 531	-7.11	7.45	-8.99
Shanghai Composite	2 890	-1.63	0.75	-5.25
VIX - Implied Volatility Index	41.84	62.11	31.20	203.63

Source: Bloomberg, Ostrum Asset Management

## Writing



**AXEL BOTTE**  
STRATEGIST  
axel.botte@ostrum.com

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Tél. : 01 58 19 09 80