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## The US dollar tanks

### Key Points

- **Renewed diplomatic tensions between the US and China**
- **Europe advances with ambitious stimulus**
- **The Fed will maintain easy policy ahead of new fiscal impulse**
- **Credit spreads tighten amid equity volatility**

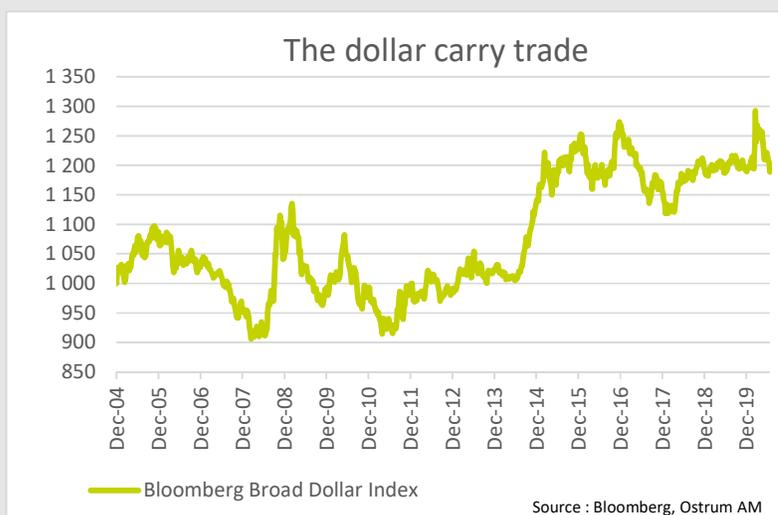
Renewed tensions between the US and china overshadowed positive investor sentiment following the agreement on a €750b recovery fund in Europe. Equity markets lost 2% last week with Shanghai down as much as 3%.

The broad-based drop in the dollar accelerated as Congress tries to secure a new round of fiscal stimulus worth 1T. The euro busted through the \$1.17 mark. Bond markets are trading sideways despite flattening pressure across yield curves, especially at the US long en. US 30y yields hover about 1.20%. As concerns credit, slower primary

issuance ahead of quarterly earnings publications contributed to spread narrowing. Euro credit spreads tightened by 10bp last week to 125bp. The bullish trend is also observed in the US. Likewise, US high yield keeps outperforming despite higher volatility in equity space. The dollar's decline amplified reach for yield on USD denominated debt (-12bp last week). Local-currency bonds also benefitted from ongoing monetary easing.

Gold spiked in response to the dollar's fall breaching the \$1900 mark.

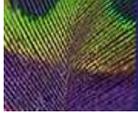
### Chart of the week



Excess demand for the dollar at the height of the financial crisis has waned. Financial stress always favored a stronger dollar given USD margin call needs on most derivative contracts.

Fed interventions have reduced excess demand for the greenback as foreign exchange markets now focus on US macro disequilibrium, including a historic federal deficit in 2020.

The dollar could again be the funding currency for carry trades as was the case through the 2002-2008 period.



## Europe emerges amid US-China tensions escalate

Financial markets have been jolted by increased international tensions, worrying developments regarding the epidemic and a major agreement on a recovery fund in Europe.

US authorities closed the Chinese Consulate in Houston on accounts of intellectual property theft. Beijing reacted by closing the US consulate in Chengdu. Escalating tensions sound like a desperate attempt by the Trump administration to divert public opinion from an increasingly difficult internal health situation. Stricter confinement measures threaten to jeopardize the nascent economic recovery, seen in rising activity surveys and bouncing retail spending. The US recovery is hence fragile. Unemployment benefits make up fully 6% of personal disposable income. Federal transfers of \$600 per week will soon expire and Congress still has to find an agreement on yet another \$1T fiscal package. Federal deficit is out of control. The Trump Administration is trying hard to change an environment that clearly favors a Democratic sweep in November. Polls indeed hint at a landslide Democratic victory this fall.

## European recovery fund is agreed

In Europe, leaders have come to an agreement after hard negotiations on an ambitious 750b recovery fund. Direct grants to governments will amount to 390b to be disbursed between 2021 and 2023. EU loans totaling €360b will supplement grants. Green investments will account for 30% of total spending. Getting approval from the so-called frugal 4 countries required a reduction in the multiyear EU budget and rolling rebates on budget contributions of the frugal four and Germany. This would never have been possible with the UK sitting at the negotiating table. That said, the main features of the EC proposal were agreed and the EU budget will double to 2.6% over the next 4 years. The financing strategy includes issuance of bonds maturing beyond 2028, as the EU will instantly become a dominant AAA issuer in euro bond markets. In all likelihood, so-called green and social bonds will make up a large part of the EU's funding strategy.

## Yield inertia, spread tightening amid equity volatility

US bond yield inertia is a by-product of fiscal dominance as Fed policy must fund overblown deficits. The size of the deficit dictates money creation at this juncture.

Additional borrowing worth \$1T will be fully absorbed by the Fed before policymakers shift to a yield targeting

framework. This market backdrop reduces volatility and thus favors carry trades all the more so that international tensions have increased of late. Curve flattening has now resumed in spite of the expected long-end issuance.

In the euro area, the ECB will keep monetary policy highly accommodative for years to come. Many reference rates (deposit, repo, Bunds) hovered about -0.50%. The bullish consensus on peripheral bonds is only reinforced by current market conditions. Italian spreads (149 on 10-year maturities) are now trading below year-end levels. Spain and Portugal spreads are about 85bp. Given QE flows, bank investments from TLTRO-III proceeds and investor confidence following the EU recovery fund, sovereign spreads can only continue to narrow.

Credit greatly benefits from lower rate volatility. The rally in spreads continues on both sides of the Atlantic. Investment grade benchmark indices are trading around 120-130bp against risk-free benchmark bonds. ITraxx IG is trading below 60pb. Lower primary issuance activity in early July ahead of the earnings season, central banks' buying and reach-for-yield flows contributed to maintain excess demand for corporate credit. Credit ETF inflows keep piling up, especially in USD markets. In the euro area, cyclical sectors (autos, media) outperformed in July.

High yield is still well bid despite higher equity volatility. Speculative-grade bonds offer average spreads around 482bp in the euro area (-25bp last week) which may be sufficient to compensate investors for 3-4% default rate this year. The deterioration will be more pronounced in the US. We have already observed a rise in defaults and Moody's projections are for 12% defaults in 2020. Energy, retail, transport and leisure are among the worst hit sectors by the pandemic. Average US high yield spreads stand at 504bp.

Equity markets reacted unfavorably to escalating tensions between the US and China. Earnings releases came in better than anticipated. Sales benefitted from improving activity towards the end of 2Q 2020. That said, the amount set aside by US banks (provisions for future loan losses) totaled a whopping \$37b in the second quarter.

Lastly, the decline in the US dollar appears to be gaining strength. The euro broke above the \$1.17 threshold. In turn, the Japanese is indeed appreciating towards 105 and currencies of countries exposed to China's economic recovery (AUD for instance) are also well oriented. US macro disequilibrium have thus pushed the dollar lower which in turn is a boon for gold which skyrocketed through the \$1900 mark.

## Main Market Indicators

Emprunts d'Etats	27-juil.-20	-1sem (pb)	-1m(pb)	2020 (pb)
EUR Bunds 2a	-0.67 %	+0	+4	-7
EUR Bunds 10a	-0.49%	-3	-1	-31
EUR Bunds 2s 10s	18 bp	-4	-5	-24
USD Treasuries 2a	0.15 %	+1	-1	-142
USD Treasuries 10a	0.59 %	-2	-6	-133
USD Treasuries 2s 10s	43 bp	-3	-4	+8
GBP Gilt 10a	0.11 %	-4	-6	-71
JPY JGB 10a	0.02 %	-1	+1	+3
EUR Spreads Souverains (10a)	27-juil.-20	-1sem (pb)	-1m(pb)	2020 (pb)
France	30 bp	+1	-5	+0
Italie	148 bp	-9	-29	-12
Espagne	83 bp	+2	-11	+18
Inflation Points-morts (10a)	27-juil.-20	-1sem (pb)	-1m(pb)	2020 (pb)
EUR OATi (9a)	60 bp	+6	+10	-
USD TIPS	151 bp	+6	+19	-28
GBP Gilt Indexés	295 bp	+5	+10	-16
EUR Indices Crédit	27-juil.-20	-1sem (pb)	-1m(pb)	2020 (pb)
EUR Credit IG OAS	125 bp	-10	-21	+32
EUR Agences OAS	49 bp	-4	-5	+5
EUR Obligations sécurisées OAS	39 bp	-2	-3	-3
EUR High Yield Pan-européen OAS	482 bp	-25	-41	+178
EUR/USD Indices CDS 5a	27-juil.-20	-1sem (pb)	-1m(pb)	2020 (pb)
iTraxx IG	59 bp	+0	-11	+15
iTraxx Crossover	356 bp	+9	-42	+150
CDX IG	70 bp	+0	-10	+25
CDX High Yield	469 bp	+1	-68	+189
Marchés émergents	27-juil.-20	-1sem (pb)	-1m(pb)	2020 (pb)
USD JPM EMBI Global Div. Spread	447 bp	-12	-23	+156
Devises	27-juil.-20	-1sem (%)	-1m(%)	2020 (%)
EUR/USD	\$1.176	+2.76	+4.7	+4.68
GBP/USD	\$1.288	+1.81	+4.87	-2.89
USD/JPY	¥105.26	+1.91	+2.38	+3.15
Matières Premières	27-juil.-20	-1sem (\$)	-1m(\$)	2020 (\$)
Brent	\$43.0	-\$0.3	\$2.0	-\$19.5
Or	\$1 936.7	\$120.6	\$166.8	\$413.9
Indices Actions	27-juil.-20	-1sem (%)	-1m(%)	2020 (%)
S&P 500	3 229	-0.69	7.33	-0.04
EuroStoxx 50	3 303	-2.52	3.08	-11.81
CAC 40	4 940	-3.02	0.61	-17.37
Nikkei 225	22 716	-0.24	0.91	-3.98
Shanghai Composite	3 205	-3.29	7.57	5.09
VIX - Volatilité implicite	25.59	4.62	-26.32	85.70

Source: Bloomberg, Ostrum Asset Management

## Writing



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