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ECB monetary overkill

Key Points

- Draghi ever more dovish ahead of June FOMC
- Risk assets rebound
- Bund yields at all-time low, Portugal 5-year yields in negative territory
- Credit should keep tightening in the wake of euro sovereign rally

Equity markets went up sharply last week. US stock markets price in Fed easing after disappointing job growth in May. T-note yields plunged temporarily below 2.10% before moving back up slightly.

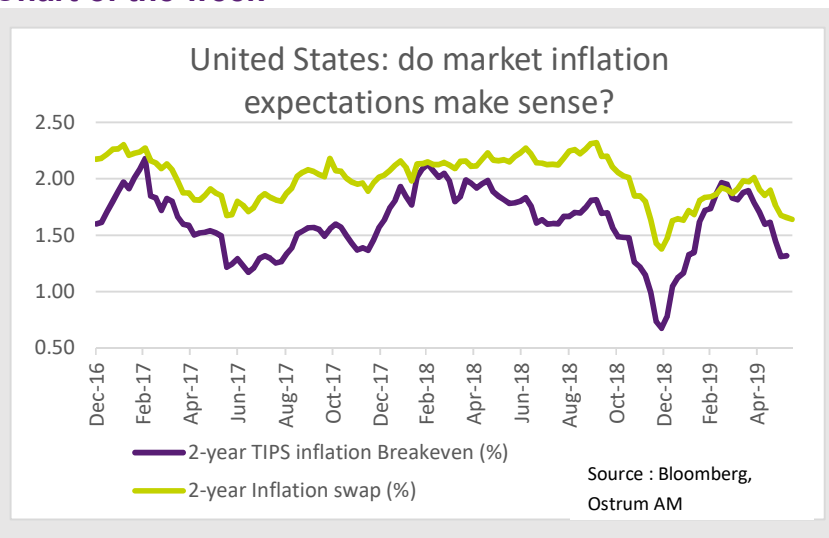
The ECB sent dovish signals resulting in significant narrowing in sovereign and credit spreads. The yield on German Bunds hit new lows at -0.23%. Italy, under pressure from the European Commission, is said to be willing to avoid clash. Ten-year BTP spread came in within 260bp. TLTRO-III conditions turned out more favourable than anticipated.

In the UK, Gilts outperformed. Boris Johnson threatened not to pay the Brexit bill that Theresa May negotiated earlier on. Rating agencies somewhat surprisingly claimed that failure to pay would not be considered default.

The euro is up above \$1.13 as investors' attention now turns to the next Fed meeting.

New tariffs on Mexican goods have finally been avoided. Mexican peso erased recent weakness. Spreads on emerging debt narrowed.

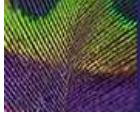
Chart of the week



James Bullard (Fed) considered that the decline in inflation breakevens justifies cutting rates. The breakeven derived from 2-year TIPS stands at 1.30% and inflation swap rates trade at 1.64%.

However, most economists forecast inflation close to 2% over the two-year timeframe. Our own model projects 2.05%.

Flight to quality likely reduced inflation breakevens. If so, receiving actual realized inflation should produce excess returns going forward.



Draghi's dovish legacy

The ECB turned out to be even more dovish than we had expected last week. Current monetary policy remains unchanged but the pricing of the next TLTRO-III includes an incentive mechanism that is quite favourable to euro area banks. The interest rate on 2-year maturity loans will be variable. The maximum rate will be refi rate plus 10bp. The low rate will be deposit rate plus 10bp. Banks for which net lending is growing will get the bonus rate if credit rises by 2.5% over the next 2 years. For banks (Italian and Spanish institutions notably) with declining lending, curbing the pace of decline will be enough to benefit from the low rate. It is hence quite likely that most banks using TLTRO-III financing will benefit from the minimum rate (deposit rate plus 10bp spread). It is worth noting that Draghi hinted at discussions to cut rates further. Furthermore, a tiering mechanism for interest rates on bank reserves would reduce the negative effect of further cuts on banking margins. The only risk faced by the ECB may be the lack of interest of German and French banks for TLTRO-III. Demand shortfall would reduce ECB balance sheet from September and contribute to a rebound in the euro. The Fed's response will obviously be critical.

The June 19 FOMC is much awaited by financial market participants. Markets price in fully 75bp worth of cuts over the year to come. Many concluded that Jerome Powell's commitment to 'appropriate' action foreshadowed a rate cut. It could be overreaction to market weakness in May and the ongoing trade war. Job growth slowed last month and GDP is expanding at a softer pace this quarter than in 1q19 (3%). That said, the Fed's estimate for potential growth is 1.75%. The current slowdown is thus reversion to potential output. Powell risks being too dovish relative to the Fed's dual mandate and identified financial stability risks or triggering another drawdown in equity markets by maintaining the rate status quo announced in March. Fed independence is dubious in the context of the resumption of net Treasury bond purchases from October. A dovish scenario remains our central case. Whilst the Mexico crisis was resolved swiftly, escalation in the China-US trade feud continues to be a source of volatility in markets.

In the UK, Boris Johnson, the leading candidate to replace Theresa May, announced that the UK will not pay the Brexit deal owed to EU during the transition period. Non-payment of €44b liabilities is not considered default by rating agencies. France made it clear that it disagrees.

Markets beg from monetary easing

Rate forecasts have created stress in repo markets particularly for 'special' securities. The yield on 10-year notes dipped under 2.10% late last week. Such market context contributed to a steeper curve. The 5s30s spread widened further which emphasizes both directionality embedded in 5-year bonds and long-term risks. Inflation-linked bonds point to an unlikely future inflation outcome in our opinion. Two-year breakevens are trading near 1.30% whilst core CPI however about 2%y. To make sense of such levels, one has to assume repeated negative shocks on oil prices for instance.

In Europe, the ECB's stance pushes sovereign spreads tighter, including that on Italian bonds despite the launch of excessive deficit procedure by the European Commission. The government appears willing to avoid a clash with the EC but refuses to pencil in the promised VAT hike. In any case, the 2020 budget shortfall amounts to €23b or 1.5pp of GDP. That said, spreads have eased. As even Portuguese bond yields with 5-year maturity now trade in negative territory, investors are forced into buying Italian or Greek debt. However, long-term bond spreads will continue to reflect challenges faced by Italian public finances.

Equities rebounded last week buoyed by expectations of Fed easing and dovish Draghi. This is a bit of a paradox at a time when the flow picture remains unfavourable. Downward earnings revisions continue which makes the rally look even more artificial. Sector performance in the US market shows strength in high-beta space including technology hardware (+6% last week) in spite of the ongoing trade war. Retail also outperformed. Short covering partially fed the rally. In Europe, the rise in the euro limited the upside on equity markets.

In credit markets, the sharp narrowing in CDS spreads foreshadowed spread tightening across cash corporate bond markets. Indeed, iTraxx IG spreads (61bp) retraced two-thirds of the May widening (+15bp). A turnaround is indeed visible in euro IG cash markets where spreads have come in by 7bp last week. Financials outperformed slightly but spread tightening is rather homogenous across credit sectors. High yield benefitted from stronger investor risk appetite. The speculative-grade rally resulted in 35bp spread tightening last week in Pan-European markets. That said, recent data suggests that high yield fund outflows, continue.

Main Market Indicators

G4 Government Bonds	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.67 %	-2	-5	-6
EUR Bunds 10y	-0.23%	-3	-19	-47
EUR Bunds 2s10s	44 bp	0	-13	-42
USD Treasuries 2y	1.94 %	+5	-33	-55
USD Treasuries 10y	2.16 %	+3	-31	-53
USD Treasuries 2s10s	22 bp	-3	+2	+2
GBP Gilt 10y	0.85 %	-5	-28	-43
JPY JGB 10y	-0.11 %	-1	-6	-11
€ Sovereign Spreads (10y)	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	35 bp	-5	-5	-12
Italy	254 bp	-18	-19	+4
Spain	81 bp	-7	-22	-37
Inflation Break-evens (10y)	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	79 bp	-7	-21	#VALEUR!
USD TIPS	173 bp	-3	-15	+2
GBP Gilt Index-Linked	347 bp	+8	+16	+29
EUR Credit Indices	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	122 bp	-7	+6	-30
EUR Agencies OAS	53 bp	-2	-1	-7
EUR Securitized - Covered OAS	48 bp	-2	-3	-15
EUR Pan-European High Yield OAS	385 bp	-35	-17	-128
EUR/USD CDS Indices 5y	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	60 bp	-7	-7	-28
iTraxx Crossover	268 bp	-28	-21	-86
CDX IG	60 bp	-7	-5	-28
CDX High Yield	347 bp	-31	-10	-103
Emerging Markets	11-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	354 bp	-30	+2	-61
Currencies	11-Jun-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.132	+0.64	+0.73	-1.18
GBP/USD	\$1.272	+0.26	-1.76	-0.2
USD/JPY	¥108.57	-0.31	+0.53	+1
Commodity Futures	11-Jun-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$62.4	\$0.4	-\$7.2	\$7.5
Gold	\$1 326.2	\$2.7	\$25.8	\$44.6
Equity Market Indices	11-Jun-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 895	3.27	0.47	15.48
EuroStoxx 50	3 406	2.17	1.34	13.48
CAC 40	5 413	2.76	1.61	14.43
Nikkei 225	21 204	3.90	-0.66	5.94
Shanghai Composite	2 926	1.23	-0.46	17.32
VIX - Implied Volatility Index	16.15	-4.83	0.69	-36.47

Source: Bloomberg, Ostrum Asset Management

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