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Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

Document intended for professional clients

24 June 2019 /// n°21-2019

Fed: losing patience

Key Points

- **Fed statement hinting at rate cut in near future**
- **Market equilibrium crucially depends on cut being delivered**
- **Treasuries: steepening and wider inflation breakevens to come**
- **Lower dollar benefits risk assets**

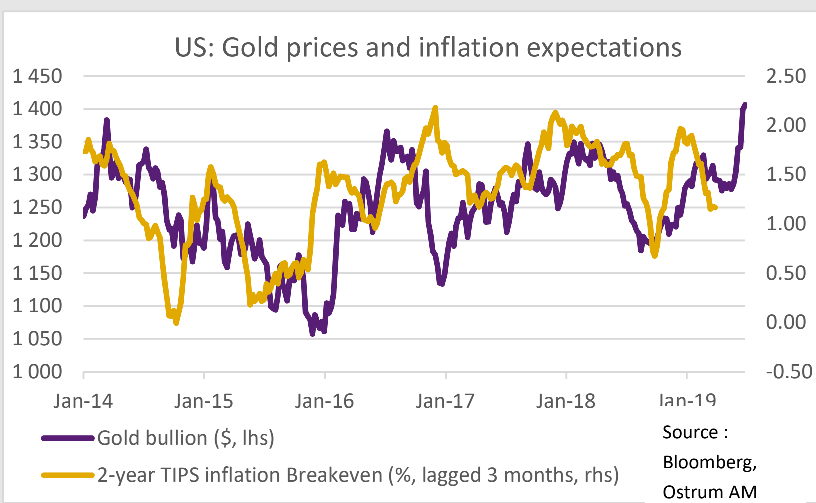
The Fed's statement only confirmed market expectations. Easing is coming, which keeps the yield curve steep (+6bp last week on 2s10s). The outlook for lower rates is a boon for risky assets. The S&P 500 gauge and European markets both gained 2% last week whilst Shanghai went up 4%.

Crypto currencies had a great run. So did gold as prices rose 5% helping breakeven inflation rates higher. Gulf tensions have also resulted in higher oil prices.

In Europe, Mario Draghi's speech sparked a sharp market reaction pushing 10-year Bund yields below -0.30%. Most sovereign spreads declined. Credit benefitted from reach-for-yield flows following tightening in synthetic credit spreads.

The dollar was weaker against both developed market currencies and emerging currencies. For example, the euro-dollar exchange rate is now quite close to the $1.14 mark.

Chart of the week



According to FOMC participants, more accommodative policy is required in response to lower inflation expectations.

The dollar decline due to lower rate expectations ignited a rise in gold prices, which generally signals fear of purchasing power loss.

If historical correlation holds, breakeven inflation rates should creep higher towards levels consistent with the Fed's target.

Fed: losing patience

The Fed described growth as moderate. Activity is underpinned by strong consumer spending although business fixed investment appear less robust. Available data suggest growth of around 2% at annualized rate in the second quarter. Inflation is below target and the market-based measures of inflation expectations have turned down in the last few weeks. The currently benign economic situation justifies no US monetary adjustment.

Yet changes in the wording of central bank communiqués usually have consequences. The Fed depicts a situation of increased uncertainty. Renewed tensions between China and the United States and the Iranian situation foster a deleterious international backdrop ahead of the G20 in Japan. The word 'patience' was indeed removed from the statement, which has fanned expectations of a July cut. The Fed has a window to lower interest rates before inflation rises again towards the end of the year. A one-and-done scenario of a 50bp cut in July appears most likely. However, the FOMC is divided into two camps: eight policymakers are in favour of status quo; seven prefer to lower rates by 50bp in total this year. Richard Clarida and other recently-appointed governors (Randy Quarles, Michelle Bowman) might have been able to convince Jerome Powell to change the course of interest rates in a matter of just six months. For operational reasons, a rate cut would be in line with the previously announced end of quantitative tightening next September.

The rally is conditional to Fed action

The rate cut expected by market participants is crucial to maintain current financial market equilibrium. The Fed put itself in a situation where status quo on rates may spark resumption of selling. The rhetorical change validated the S&P rise to new highs. High beta technology stocks and industrials outperformed whilst the energy sector was boosted by higher oil prices. Financials did less well in part due to the fall in rates. US small caps continue to underperform their large-cap counterparts. The equity positioning of asset allocators is however not excessive but continued equity fund outflows do raise the question of the sustainability of the rally.

In US bond markets, bullish consensus may hint at the risk of correction but leveraged players appear to hold on to sizeable short positions, which in turn could spell buybacks. A neutral stance is warranted on duration in US Treasuries. The yield curve is steepening, as promised easing keeps 2-year yields lower than 10-year yields (2.03%) The 5s30s spread is most attractive to gain steepening exposure. The spread widened from 25bp in late September to 77bp currently. The steepening trend may continue as inflation expectations creep higher. In parallel, current 30-year bond valuations could be under more scrutiny if the Fed does reassess the duration profile of its portfolio over the coming year.

US inflation-linked bonds are also well positioned to benefit from the dollar decline. Short-term inflation breakeven rates are at extremely low levels considering inertia in price gauges. Core CPI inflation is indeed steady about 2%y. US credit and emerging market bonds also enjoy lower US rates and dollar depreciation. Leaving Turkey aside, volatility in investable emerging bonds is quite limited. Carry trades are hence fostered. Peru's tender offer on its USD debt is another favourable signal for the asset class.

ECB: 'Whatever…'

In the euro area, Mario Draghi appears willing to tie his successor's hands by waiving the risk of further cuts and possible resumption of net asset purchases. The interest rate scheme of TLTRO-III depends on deposit rates. The ECB likely judged that signalling the possibility of cuts could contribute to raise loan take-up at the September loan deal. One can, easily imagine that the ECB stands ready to expand net asset purchases to include unsecured bank bonds. The reduction in TLTRO-III maturity to just 2 years aims at incentivizing banks to increase market borrowing.

Sovereign bond yields have made now all-time lows. German Bunds are trading under the -0.30% mark in a bond market fled by institutional investors. Reach-for-yield keeps yield curves flat. OAT yields now oscillate about 0% on 10-year maturities, which discourages even Japanese investors. Iberian Bonos continue to attract large demand. In this context, positive-yielding BTP could appear as an anomaly if only the fiscal backdrop was not as dire. The EU may launch an excessive deficit procedure against Italy in early July.

European corporate bonds represent the alternative to ever lower sovereign bond yields all the more so even long-term sovereign bond spreads have now shrunk considerably. Credit fund inflows have resumed and pushed spreads tighter. The average spread on European investment grade corporate bonds stands at 112bp against German government debt. Market yields indeed tightened fully 10bp last week. High yield recorded even more significant spread tightening with a 50bp decline. The yield gap between high yield corporate bonds and German Bunds is now just 333bp.

Main Market Indicators

G4 Government Bonds	24-Jun-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.74 %	-5	-11	-13
EUR Bunds 10y	-0.31%	-6	-19	-55
EUR Bunds 2s10s	44 bp	-1	-8	-42
USD Treasuries 2y	1.73 %	-14	-44	-76
USD Treasuries 10y	2.02 %	-7	-30	-66
USD Treasuries 2s10s	29 bp	+7	+14	+9
GBP Gilt 10y	0.82 %	-3	-14	-46
JPY JGB 10y	-0.15 %	-3	-8	-16
€ Sovereign Spreads (10y)	**24-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	33 bp	-2	-7	-14
Italy	246 bp	-8	-21	-4
Spain	72 bp	-5	-23	-46
Inflation Break-evens (10y)	**24-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	80 bp	+14	-8	#VALEUR!
USD TIPS	171 bp	+9	-6	0
GBP Gilt Index-Linked	334 bp	-4	+1	+16
EUR Credit Indices	**24-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	112 bp	-10	-7	-40
EUR Agencies OAS	51 bp	-2	-3	-9
EUR Securitized - Covered OAS	49 bp	+1	+0	-14
EUR Pan-European High Yield OAS	333 bp	-50	-53	-180
EUR/USD CDS Indices 5y	**24-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	54 bp	-7	-14	-34
iTraxx Crossover	257 bp	-18	-38	-97
CDX IG	56 bp	-5	-9	-32
CDX High Yield	325 bp	-31	-40	-126
Emerging Markets	**24-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	342 bp	-19	-11	-73
Currencies	**24-Jun-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.139	+1.46	+1.67	-0.54
GBP/USD	$1.273	+1.38	+0.13	-0.12
USD/JPY	¥107.37	+1.12	+1.81	+2.13
Commodity Futures	**24-Jun-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$64.3	$3.4	-$3.2	$9.4
Gold	$1 414.9	$75.1	$129.9	$133.3
Equity Market Indices	**24-Jun-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 952	2.17	4.47	17.77
EuroStoxx 50	3 456	2.14	3.13	15.13
CAC 40	5 522	2.43	3.86	16.72
Nikkei 225	21 286	0.77	0.80	6.35
Shanghai Composite	3 008	4.17	5.44	20.62
VIX - Implied Volatility Index	15.37	0.13	-3.03	-39.54

Source: Bloomberg, Ostrum Asset Management

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