

STRATEGY WEEKLY

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ECB doves flying high

Key Points

- **Sintra speech engineered expectations of massive monetary easing**
- **Yields resume declining**
- **High yield spreads widening**
- **Profit-taking in equity markets**

Financial markets patiently await for ECB (July 25th) and Fed (July 31st) meetings. The scope of monetary easing to come is being debated. The downtrend in bond yields resumed as investors take profits on equities. The S&P 500 equity gauge retreated below 3000 losing 1.2% last week. Earnings season is off to a cold start. Volatility however stayed muted. Bund trade under the -0.30% threshold. In the US, 10-year note yields are barely above 2%.

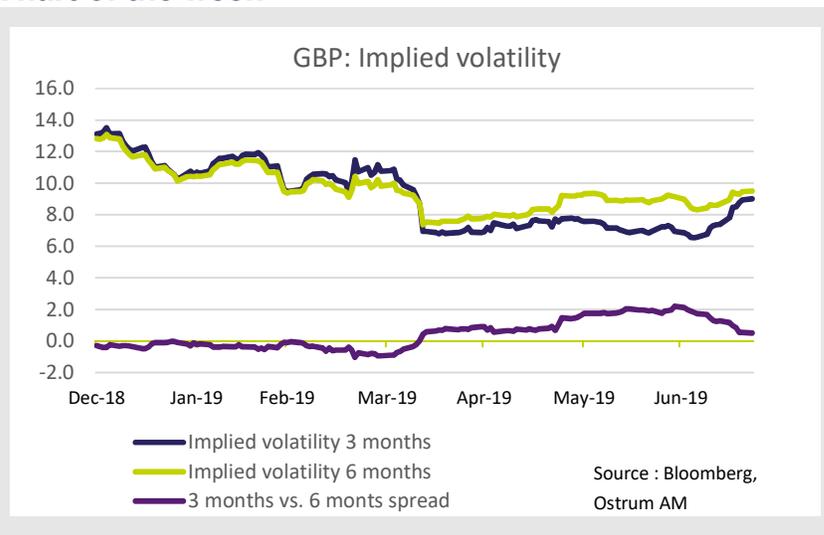
Euro credit still attracts good institutional demand. Swap spreads tighten in the wake of the recent

sovereign rally. Political risk is again in the spotlight in Italy. BTP underperformance is so far limited. High yield is wider. The spread on this asset class increased fully 25bp last week to 372bp against Bunds. Yet, iTraxx XO still hovers about 250bp.

Tories will have to choose the new Prime Minister. Boris Johnson is the favourite despite ongoing opposition of Parliament. Sterling trades below \$1.25.

Emerging spreads are trading sideways near 335bp vs. US Treasury bonds.

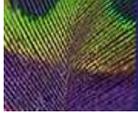
Chart of the week



In the UK, the Tories leadership contest is underway. The new conservative leader to take over from Theresa May will be announced on Tuesday. Hard-Brexiter Boris Johnson is the favorite against Jeremy Hunt.

UK Parliament's vote last week to block no-deal Brexit and Philipp Hammond' resignation from government underlie the depth of the political crisis.

In financial markets, complacency early on this year is giving way to higher levels of risk being priced. Implied volatility on Sterling is set to increase.



Draghi to hammer Sintra message, action in September

The ECB meets this week. After Mario Draghi's speech in Sintra in late June, expectations for a new round of monetary easing are running high. The July 25th meeting will be the occasion to sharpen guidance as it relates to new asset purchases and possible rate cuts.

The likely pick-up in inflation from 1.3% currently to 1.5% by the end of the year will be insufficient to prevent the expected dovish turn. The definition of price stability is being debated within the Governing Council. It is not impossible that the ECB's inflation target changes to a symmetric objective around 2%, similar to that of the Federal Reserve. In doing so, the ECB will always be able to justify policy easing given the prolonged period of low inflation. The hidden objective is likely to ensure solvency of battled member states where fiscal issues threaten the stability of the monetary union. However, expansionary monetary policy is far from riskless. On top of being inefficient to raise prices, the ECB's policy weighs on potential growth by postponing corporate restructuring and slowing resource reallocation within the economy. We believe that the ECB will reduce deposit facility rates in September and stands ready to restart asset purchases in the fourth quarter, including buying unsecured bank bonds if necessary. The next steps will crucially depend on bank demand at upcoming TLTRO-III. If less favourable terms do result in lower loan demand (and hence ECB balance sheet shrinks), the euro will likely tend to appreciate. The ECB may then be inclined to cut rates, all the more so TLTRO-III rates are indexed to deposit rates (currently at -0.40%). The exoneration of negative rates on part of bank reserve holdings would allow the ECB to cut rates more aggressively. Indeed, markets estimate that there is a 10% chance of -0.80% deposit rate by March 2020.

Remember March 2015

In financial markets, Bund yields resume trading below -0.30%. The 2s10s spread is just 43bp, in line with the level that prevailed before the start of PSPP in March 2015. Such similarity does suggest that bond markets expect net asset purchases to resume shortly. Bullish bond positioning is quite consensus at present. And, bullish consensus entails asymmetrical positioning risk, if for example, policymakers cannot agree on technical changes to current PSPP constraints (ISIN and 33% debt holdings limits). The exit door could turn out to be too narrow for market participants. Furthermore, relative scope of rate cuts and asset purchases will be a determining factor for swap spreads. Deposit rate cuts favour swaps, whilst more QE would likely widen

swap spreads. The tightening bias in swap spreads is maintained. Opportunities have shrunk in sovereign bond space. Spain (despite difficulties to form a government) and Portugal still represent value. The possibility of early elections in Italy revived spread volatility. BTP still trade with 200bp on 10-year maturities.

Final investors continue to pile on investment-grade corporate bonds. Credit fund inflows have nevertheless slowed to a degree. IG spreads in euro hover about 104bp against German Bunds. In high yield space, net buying flows remain significant but current valuations raise questions. Spreads (at 372bp vs. Bunds) increased by 25bp last week. Many BB-credits have negative yields to maturity, which makes no sense for speculative-grade securities. Other features are worth mentioning. In the US in particular, many bonds trade above call prices which result in significant extension risk (or negative convexity risk). High yield underperformance in the US would likely result in a similar move in European speculative-grade corporate bond markets. That said, it is worth noting that CDS indices barely budged so far.

Equity markets have retraced part of their recent performances without excessive volatility. Euro Stoxx 50 is below the 3500 mark. The absence of final investor buying is nevertheless still worrisome. European markets are pulled down by the banking sector woes and the resource and commodities sector. The 'good' news for banks is that performance does not overshoot earnings revisions. The transport sector bounced on lower energy prices.

The drop in oil prices is a reminder of excess supply building gradually even as OPEC+ confirmed its supply restraint policy. That said, its' worth noting outperformance from inflation linkers, which hints at renewed interest for this forgotten asset class.

US stock valuations tested amid poor earnings season

In the US, earnings season is off to a cold start. Valuations may not be low enough to accommodate earnings disappointments even if expected Fed moves do provide a cushion to the US equity market in aggregate. In addition, there is no sign of excess investor positioning on US equities (to say the least). Reported earnings growth is less than 2%q in 2q19 and projections are for a decline in profits in the third quarter. After about a third of publications, financials show the strongest results with 3-4% quarterly earnings growth. Conversely, initial releases in commodity-related sectors were particularly downbeat.

Main Market Indicators

G4 Government Bonds	22-Jul-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.77 %	-4	-4	-16
EUR Bunds 10y	-0.35%	-10	-6	-59
EUR Bunds 2s10s	43 bp	-6	-3	-43
USD Treasuries 2y	1.8 %	-2	+4	-68
USD Treasuries 10y	2.03 %	-6	-2	-66
USD Treasuries 2s10s	23 bp	-3	-6	+3
GBP Gilt 10y	0.71 %	-9	-14	-57
JPY JGB 10y	-0.14 %	-2	+2	-14
€ Sovereign Spreads (10y)	22-Jul-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	26 bp	+0	-7	-20
Italy	200 bp	+10	-44	-50
Spain	74 bp	-2	+1	-44
Inflation Break-evens (10y)	22-Jul-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	90 bp	+2	+7	-
USD TIPS	179 bp	+0	+5	+7
GBP Gilt Index-Linked	332 bp	+6	-2	+15
EUR Credit Indices	22-Jul-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	104 bp	-1	-12	-48
EUR Agencies OAS	46 bp	-1	-5	-14
EUR Securitized - Covered OAS	44 bp	-1	-4	-20
EUR Pan-European High Yield OAS	372 bp	+25	+19	-141
EUR/USD CDS Indices 5y	22-Jul-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	48 bp	0	-6	-40
iTraxx Crossover	250 bp	+7	-7	-104
CDX IG	53 bp	0	-2	-35
CDX High Yield	332 bp	+7	+8	-118
Emerging Markets	22-Jul-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	335 bp	+0	-19	-80
Currencies	22-Jul-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.122	-0.36	-1.49	-2.03
GBP/USD	\$1.248	-0.26	-2.03	-2.09
USD/JPY	¥107.88	-0.01	-0.5	+1.65
Commodity Futures	22-Jul-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$63.3	-\$3.1	-\$1.1	\$8.4
Gold	\$1 426.7	\$13.6	\$11.6	\$145.1
Equity Market Indices	22-Jul-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 984	-1.02	1.13	19.02
EuroStoxx 50	3 490	-0.35	0.66	16.28
CAC 40	5 567	-0.20	0.70	17.68
Nikkei 225	21 417	-1.24	0.74	7.00
Shanghai Composite	2 887	-1.88	-3.83	15.76
VIX - Implied Volatility Index	14.00	10.41	-9.09	-44.93

Source: Bloomberg, Ostrum Asset Management

Writing



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