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STRATEGY WEEKLY

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Fed: the obligatory cut

Key Points

- **ECB: Mario Draghi will end his term by cutting rates**
- **Restart of asset purchases will complete ECB easing strategy**
- **Fed to cut rates this week**
- **Euro IG spreads keep narrowing**

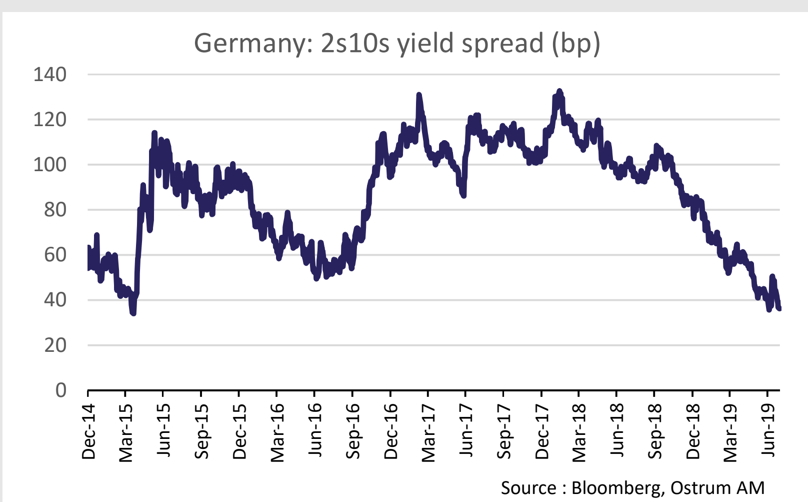
Mario Draghi's message last week kept alive all expectations for monetary easing in September. A rate cut is likely. A subsequent resumption of asset purchases is firmly on the table. In turn, the Fed will also cut rates this week despite 2q19 growth falling in line with potential.

Expected monetary support pushed US equity markets to new highs. The S&P closed at 3025 after a 1.7% weekly advance. Volatility is still muted despite lacklustre earnings season.

US yields are stable about 2.05% on 10-year maturities. Bund trades close to -0.40%. Euro credit remains in high demand given prospects for new asset purchases. High yield is more volatile owing to rich valuations. There is decompression across the rating structure of credit spreads.

Currency markets show some volatility. The euro settled under the $1.12 threshold. Sterling is gradually pricing in a higher probability of hard Brexit. In turn, Australian dollar resumed falling as the RBA contemplates further rate cuts.

Chart of the week



The yield curve flattened considerably since last autumn. The 2s10s spread is down from 108bp on October 5th to 36bp at present.

The flattening trend reflects predominantly expectations of new asset purchases. Markets are front-running ECB purchases as in 2015 when yields rallied into the formal start of QE.

Furthermore, it is possible that short-maturity bonds could be sold after a reserve tiering mechanism is implemented. A pickup in yields could then magnify the flattening trend.

ECB easing to come

The Ecb committed to restart expansionary monetary policy. The stance confirmed the dovish bias advertised in Sintra a month ago. The policy decision release indicates a possibility of rate cuts over a one-year horizon. Along with expected reduction in rates, the ECB will study the feasibility of a reserve tiering system that would be less harmful to private-sector financial institutions. Other options are on the table to ease financial conditions further. New asset purchases are being considered on top of reinvestments of maturities. In parallel, the definition of price stability has changed, so that the ECB's objective is now symmetrical around 2%. The ECB may hence tolerate higher inflation.

Thus, Mario Draghi preannounced a deposit rate cut by 10bp in September. Further cuts which are already partially priced in markets could be conditional to the actual implementation of a reserve tiering system in order to mitigate the impact of negative rates on bank margins. On operational grounds, the reform is complex but necessary to weigh on money market rates and potentially the euro exchange rate. The macro cycle analysis presented by Mario Draghi turned out to be quite confusing but generally laid ground for new asset purchases. The renewed weakness in Germany's manufacturing PMI (43.1 in July) is a worrisome development even if there exist pockets of economic strength in construction or services. We think that new asset purchases can also be a function of demand at the upcoming TLTRO-III, which are less generous than the previous series. If banks prefer to raise funding via the bond market, there could be a case for unsecured bank bond buying. A conflict of interest linked to the ECB's bank supervision task could represent a hurdle to bank bond purchases if the ECB opts to liquidate a non-viable bank institution, in which it holds debt. Such conflict of interest may nevertheless be manageable and actually the ECB already accepts uncovered bank bonds as collateral (to the tune of €78b worth of securities).

The compulsory Fed rate cut

This week's main event is undoubtedly the July 30-31 FOMC. The Fed's monetary pivot has already materialised in the form of foregone rate hikes, anticipated ending of quantitative tightening and a modest IoER 5bp rate cut in May (IoER is one of the interest rates controlled by the Fed). A first cut in the Fed Funds rate is likely to be decided this Wednesday. The rate cut is not justified by the level of Growth (+2.3%y in 2q19), unemployment (3.7%) or the transitory dip in inflation below 2%. The dovish turn has to be seen in the context of global monetary easing. The Fed probably aims at preventing that the dollar becomes the adjustment variable of the world economic cycle (at a time when Trump's protectionism already raised the dollar's value). A 50bp rate decrease may not gather a majority within the FOMC but a large cut in IoER (say -35bp to 2%) to supplement a 25bp downshift in the Fed Funds target range is a distinct possibility. IoER is important for the Fed as it determines the funding cost of its portfolio at a time when yields on reinvested flows have fallen below the 2.35% mark (except on 30-year Treasuries). Furthermore, the rate cut is fully priced in by markets. This suggests that status quo on rates will engineer an equity market correction. The Fed is unlikely to deviate from previous guidance for lower rates.

Precarious equilibrium in markets

The current monetary backdrop favours bond markets. The Fed's message around the decision will nevertheless be quite important. Markets price in 100bp of easing over a one-year horizon. A rate decrease presented as an insurance against foreign developments is inconsistent with a full easing cycle. Yields on 2y and 5y Treasury bonds could creep higher and the yield curve may resume flattening. The bullish consensus raises retracement risk. Conversely, the 10s30s spread has room to widen under this scenario. In the euro area, the ECB's decision sparked further yield curve flattening. The 2s10s spread is making new lows quite close to the 2015 tight levels (35bp). Semi-core countries (France and Belgium) still offer a bit of a premium as the long end of the curve remains steep (95bp on OATs). Capitulation of institutional investors remains a possibility. As concerns peripheral markets, political risk in Italy has not (yet?) resulted in early general elections. Fitch ratings' decision on August 9th (BBB, watch for downgrade) has the potential to move spreads and revive volatility in BTP markets (198bp against 10-year Bunds). That said, short-maturity are well protected by monetary easing prospects. In Spain, Socialist Pedro Sanchez failed to form a government, which sparked some profit taking (76bp on 10-year spread). Furthermore, the UK's situation is making no progress. Boris Johnson is preparing for no-deal as FX and bond markets reflect broad-based pessimism. Sterling trades under $1.23 and implied FX volatility shows complacency is over regarding the black hole experiment of a no-deal Brexit. Gilt yields plunged to 0.65% as the BoE seems paralysed.

Strong demand for euro credit pushed spreads under 100bp vs. Bunds. The possibility of new CSPP purchases helped IG outperform high yield recently, in particular on synthetic CDS indices. As regards equity markets, earnings releases and guidance point to US profit contraction in 3q19. Quarterly earnings growth is less than 4%, which may not be sufficient to maintain high PE multiples. Stakes are high ahead of The Fed's rate decision.

Main Market Indicators

G4 Government Bonds	29-Jul-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.76 %	+1	-1	-15
EUR Bunds 10y	-0.39%	-5	-6	-63
EUR Bunds 2s10s	37 bp	-6	-5	-48
USD Treasuries 2y	1.85 %	+3	+9	-64
USD Treasuries 10y	2.06 %	+1	+5	-63
USD Treasuries 2s10s	21 bp	-2	-4	+1
GBP Gilt 10y	0.65 %	-5	-18	-62
JPY JGB 10y	-0.14 %	-1	+2	-15
€ Sovereign Spreads (10y)	**29-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	25 bp	-1	-7	-22
Italy	196 bp	-4	-46	-54
Spain	75 bp	+1	+3	-43
Inflation Break-evens (10y)	**29-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	89 bp	-1	+10	-
USD TIPS	177 bp	-3	+7	+5
GBP Gilt Index-Linked	335 bp	+3	+7	+18
EUR Credit Indices	**29-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	98 bp	-6	-14	-54
EUR Agencies OAS	45 bp	-1	-5	-15
EUR Securitized - Covered OAS	43 bp	-1	-5	-20
EUR Pan-European High Yield OAS	344 bp	-28	-5	-169
EUR/USD CDS Indices 5y	**29-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	49 bp	+1	-2	-39
iTraxx Crossover	246 bp	-4	-2	-107
CDX IG	52 bp	-1	-1	-35
CDX High Yield	314 bp	-18	-8	-136
Emerging Markets	**29-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	326 bp	-9	-21	-89
Currencies	**29-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.114	-0.7	-1.35	-2.72
GBP/USD	$1.223	-2.05	-3.25	-4.09
USD/JPY	¥108.85	-0.89	-0.34	+0.74
Commodity Futures	**29-Jul-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$63.5	$0.3	-$1.2	$8.6
Gold	$1 420.9	-$5.0	$34.3	$139.3
Equity Market Indices	**29-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	3 022	1.23	2.72	20.54
EuroStoxx 50	3 524	0.96	1.44	17.40
CAC 40	5 601	0.61	1.12	18.40
Nikkei 225	21 617	0.93	1.60	8.00
Shanghai Composite	2 941	1.87	-1.27	17.93
VIX - Implied Volatility Index	12.65	-6.50	-16.11	-50.24

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