Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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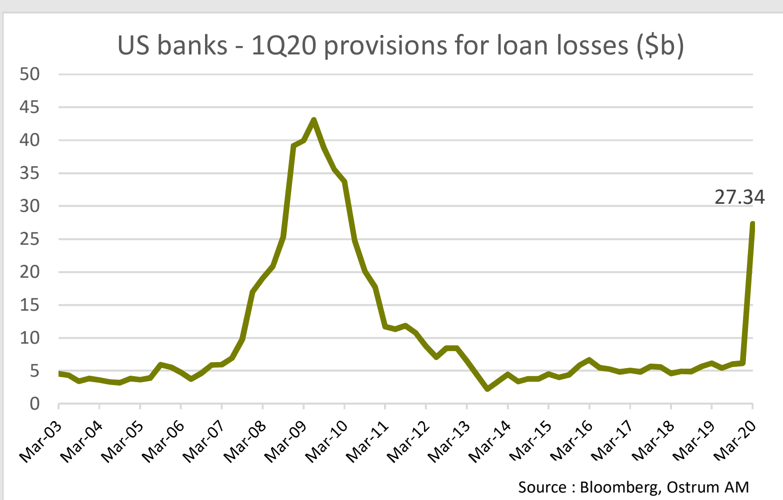
Hope vs. reality

Key Points

- **Equity markets price in a swift recovery…**
- **…even as earnings forecast plummet and…**
- **… risk-free bond yields decline**
- **Investment flows returning to credit**

Equity markets continued their ascent since the March 23 low. Major equity indices gained about 2% last week in Europe, Japan and the US alike. Hope to reopen the economy in the month to come was magnified by relatively positive data out of China for March. Yet, outperformance from cyclical sectors highly exposed to the sanitary crisis does raise questions. US 10-year notes yields fell towards 0.60% whilst Bund yields neard -0.50% again. Italian BTP spreads widened out to 225bp. Conversely credit spreads shrank by a further 23bp last week in the US (210bp vs USTs) and by 9bp in the euro area (200bp vs. Bund). The high yield market cheapened however after the sharp rally ignited by the Fed's decision to purchase bonds issued by fallen angels. CDX HY oscillates about 600bp (+67bp in the past week). European high yield bonds trade about 664bp. Oil prices plunged as WTI prices fell below the $20 threshold. In currency markets, dollar is in high demand despite Central Bank intervention. The euro fell under $1.09. The yen was firmer but gold prices dipped under $1700.

Chart of the week



One of the takeaways from the 1q20 US earnings season so far, is the considerable increase in provisions for loan losses of large US banking institutions.

The ten largest banks set aside as much as $27b in the first quarter. At the peak of 2008 crisis, loan loss provisions for this group hit $43b. The current collapse in US growth and skyrocketing unemployment foreshadows increased defaults in the coming months.

That said, US banks likely aimed at reassuring stakeholders by provisioning ahead of a steep rise in non-performing loans.

Equity markets pulled by recovery hopes

Major stock indices had undergone a 3-4% correction last Wednesday yet optimism is widespread across equity markets. Donald Trump's message hinting at reopening of the US economy was welcome by market participants. Encouraging results of Covid-19 drug tested in several countries fueled hopes for a swift return to normal. Furthermore, Chinese statistics revealed a smaller-than-anticipated contraction in industrial output in March (-1.1%y).

Yet the reality is that China's GDP plunged by an unprecedented 6.8%y in 1q20. Household spending plummeted by 19%y compared with 1q19. Investment also weakened considerably. In the US, the collapse in activity is obvious in most indicators. Retail sales plunged last month (-8.9%m). Manufacturing surveys (Empire, PhilFed) are in free fall in April as millions of Americans lose their jobs every week. The 22mn jobs added since 2009 have indeed been lost in just 4 weeks' time. Furthermore, the $349b worth of SME loans have already been fully allocated. Further government support will surely bee needed in the months to come.

S&P 500 trading at 21x 2020 earnings

A rapid recovery is indeed priced in equity valuations at present. Trading volumes have diminished since the March market collapse, when investor capitulation was widespread. Current rebound seems to be fueled by short covering. In European stock markets, the outperformance of sectors deeply hit by the sanitary crisis (automobile, leisure, transport) does raise questions. Most firms no longer provide earnings guidance. In addition, about one quarter of the market has announced dividend cuts and nearly 75% of banks will indeed reduce payouts. In the euro area, earnings per share are set to fall by 24% in 2020 but analysts expect a return to 2019 profit levels next year. In the US, S&P 500 earnings forecasts point a mere 7% decrease in EPS this year even as the relative effect from stock buybacks will be half what it was before. The expected rise in bankruptcies will weigh on potential output growth going forward. As a matter of fact, the largest US banking corporations set aside provisions for loan losses (worth $27b in the first quarter) that may be indicative of a looming credit crisis resembling 2008. Current valuations hence are unjustifiable in our opinion. Indeed, the S&P 500 benchmark is trading at 21x 2020 earnings. A fallback in market looks inevitable if a V-shape recovery turns out to be out of reach.

Risk-free yields falling again

The rise in equity valuations seems inconsistent with declining bond yields. In the short run, central bank support is indeed unlimited, and Christine Lagarde only recalled that the ECB could still do more. The yield on Bunds dropped towards -0.50%. On top of cash-risk-free bond arbitrage considerations, the choice made by Germany's debt agency to fund deficit spending by T-bill issuance likely removed pressure from increased deficits on long-term interest rates. This partly explains the flattening in the euro yield curve. In turn, the French 10s30s spread tightened in spite of public debt projected to rise to 112% in 2020. European Treasury departments have market access, thanks to ECB support, although yield concession before bond auctions are widespread, most notably in Italy and Spain of late. Italy's BTPs remain volatile and spreads have widened out to 225bp. The Italian government may tap the ESM's credit line should market funding conditions deteriorate. Hence, spreads on supranational debt may face pressure going forward.

In the US, T-note yields (0.64% at weekly close) oscillates between 0.60 and 0.70%. The steepening trend eased which allowed the Fed to reduce daily Treasury bond purchases. The US Central Bank may opt for long-term yield targeting to limit the expansion of its balance sheet as new facilities will be used to make loans to SMEs, prop up credit markets and support securitization. Spreads on mortgage-backed securities (MBS) have widened as markets take account of downside risk to housing prices, the possibility of increased default rates and liquidity risk of mortgage servicing firms.

Flows return to credit markets

In euro credit markets, the backdrop is improving as a notable upturn in investment flows appears to be developing. Spreads diminished consistently towards 200bp vs. Bunds. The ECB kept buying heavily since the start of PEPP (€50b total including credit out of €750b planned). CSPP now tops €200b. On a sector basis, financials lost ground against cyclical sectors last week. The June 2020 TLTRO-III (expected demand is around €800b) will ease pressure on bank bond issuance needs. Spreads on subordinated debt have narrowed relative to senior bonds (bail-in risk being priced in?). High yield erased part of last week's rally in the wake of the Fed's new measures. Spreads on Pan-European high yield bonds hover around 660bp.

In the US, investment grade credit remains the most attractive fixed income market. The Fed upped the ante on credit programs to $750b purchase capacity. Spreads average near 210bp over US Treasuries. Credit ETF purchases, including high yield ETFs, have fostered investor demand for credit funds. We however monitor high volatility in CDX HY spreads (+67bp over the last five trading sessions).

Main Market Indicators

Emprunts d'Etats	20-avr.-20	-1sem (pb)	-1m(pb)	2020 (pb)
EUR Bunds 2a	-0.7 %	-8	-2	-10
EUR Bunds 10a	-0.47%	-12	-15	-29
EUR Bunds 2s10s	23 bp	-4	-13	-19
USD Treasuries 2a	0.2 %	-5	-12	-137
USD Treasuries 10a	0.63 %	-14	-21	-128
USD Treasuries 2s10s	44 bp	-9	-10	+9
GBP Gilt 10a	0.32 %	+1	-25	-51
JPY JGB 10a	0.02 %	0	-6	+3
EUR Spreads Souverains (10a)	**20-avr.-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
France	51 bp	+6	+7	+21
Italie	233 bp	+39	+38	+73
Espagne	131 bp	+18	+25	+65
Inflation Points-morts (10a)	**20-avr.-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
EUR OATi (9a)	31 bp	-5	+25	-
USD TIPS	102 bp	-24	+26	-76
GBP Gilt Indexés	276 bp	-12	+7	-35
EUR Indices Crédit	**20-avr.-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
EUR Credit IG OAS	200 bp	-9	-5	+107
EUR Agences OAS	75 bp	+3	+0	+31
EUR Obligations sécurisées OAS	68 bp	+5	+13	+27
EUR High Yield Pan-européen OAS	664 bp	-34	-132	+360
EUR/USD Indices CDS 5a	**20-avr.-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
iTraxx IG	83 bp	+4	-34	+39
iTraxx Crossover	491 bp	+28	-184	+285
CDX IG	87 bp	+1	-54	+42
CDX High Yield	593 bp	+11	-204	+313
Marchés émergents	**20-avr.-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
USD JPM EMBI Global Div. Spread	607 bp	-1	+29	+316
Devises	**20-avr.-20**	**-1sem (%)**	**-1m(%)**	**2020 (%)**
EUR/USD	$1.086	-0.51	+1.62	-3.28
GBP/USD	$1.245	-0.52	+7.09	-6.1
USD/JPY	¥107.8	-0.2	+2.9	+0.72
Matières Premières	**20-avr.-20**	**-1sem ($)**	**-1m($)**	**2020 ($)**
Brent	$27.3	-$4.4	-$1.7	-$36.8
Or	$1 677.1	-$37.1	$178.4	$154.3
Indices Actions	**20-avr.-20**	**-1sem (%)**	**-1m(%)**	**2020 (%)**
S&P 500	2 875	3.04	24.71	-11.03
EuroStoxx 50	2 907	0.50	14.07	-22.37
CAC 40	4 529	0.49	11.86	-24.24
Nikkei 225	19 669	3.29	18.83	-16.86
Shanghai Composite	2 853	2.50	3.89	-6.48
VIX - Volatilité implicite	38.15	-7.34	-42.23	176.85

Source: Bloomberg, Ostrum Asset Management

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