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Karlsruhe gets involved

Key Points

- **Extended rally in equities**
- **Unprecedented fall in US employment in April**
- **Money market pricing in negative Fed Funds rates**
- **Germany's constitutional court opposes ECB policy**

The rally in equities continued last week in spite of the recession and plunging corporate earnings. The S&P 500 gained 3.5% last week. Shanghai was 3% in just three trading sessions. Europe was down 0.5% but ended the week on a positive note.

In Bond markets, the Karlsruhe constitutional court gave the ECB 3 months to explain modalities of the PSPP. The ruling fanned speculation against BTPs and the euro (-1.3% vs. the dollar last week). Italian bond spreads nevertheless tightened as Moody's left its sovereign rating unchanged at Baa3. Credit underperformed Bunds (+6bp). High yield spreads rose 11bp.

In the US, the Treasury's quarterly refunding announcement sparked steepening pressure as new 20-year benchmark securities will be auctioned this quarter. Furthermore, money markets price in negative Fed Funds by December. The Fed so far ruled out negative rates. US high yield benefitted from a pickup in oil prices. Lastly, emerging debt spreads shrank within 600bp vs. US Treasuries.

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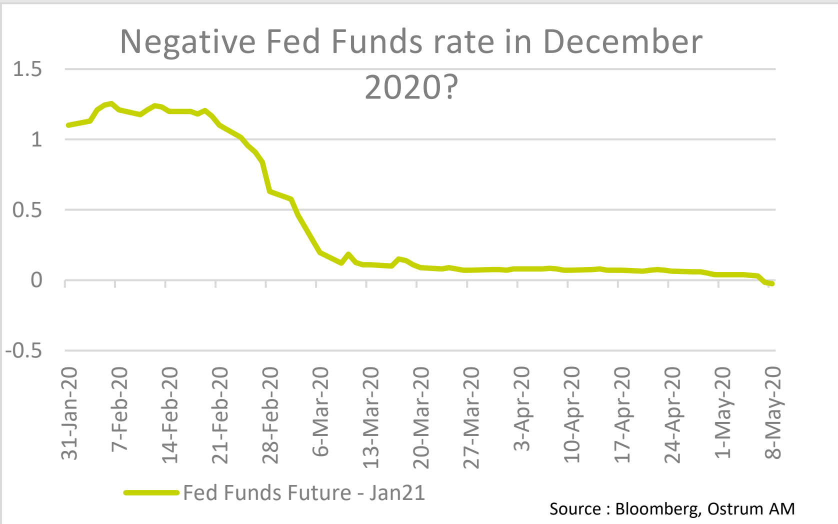
Chart of the week



In early March 2020, the Fed drove rates all the way down to 0-0,25%. Markets are now pricing in negative rates in the US.

Traded volumes on Fed Funds futures were unusually large this week. The contract will fully reflect the FOMC's decision in December. Implied rates have turned negative to -0.03%, which hints at a 15% probability of rates falling below zero. That said Thomas Barkin from the Richmond Fed weighed in saying negative rates should not be tried in the US.

A decade of job growth wiped out in a few weeks' time

Financial markets supported by hyperactive central banks are seemingly ignoring the plunge in activity. The downturn seen in the last few weeks of the first quarter is gaining traction in the second quarter. Surveys in the service sector suggest that the magnitude of the recession linked to social distancing measures is indeed unprecedented. Service PMI have fallen to around 10 on a 0-100 scale. In the US, the situation is hardly better. Lockdown measures were put in place later than in Europe. The US economy shed more than 20 million jobs in April. In a matter of only one month, a decade of job increases has been lost! The BLS survey takes the week of the 12th day of the month as reference. Initial jobless claims remain in the millions. Since then, in just three weeks' time, 11 million jobs may have been lost. The reference unemployment rate stood at 14.6% in April. The rise in the jobless rate was limited by the fall in labor market participation. Borader measures of unemployment taken into account discouraged workers and involuntary part-time workers have skyrocketed to levels unseen in the fallout of the great financial crisis of 2008. The broadest underemployment measure hit 22.8% last month compared with a peak at 17.2%. The acceleration in average hourly wages (+7,9%y in April) is obviously meaningless and mainly reflects compositional bias in sampling. Job losses disproportionately affect low-skill workers. This will be without consequences. Defaults among households will increase significantly. Indeed, according to a New York Fed study, 40% of US households would struggle to cover a $400 emergency expense. Defaults on auto loans have been rising constantly since 2014 even as the economy was operating near full employment. Provisions for loan losses announced by large US banks in the first quarter leave no doubt about asset quality going forward.

ECB attacked by Karlsruhe

The German constitutional court attacked the ECB's monetary policy again. The Karlsruhe judges demand that the ECB provides explanations regarding the proportionality of public-sector debt purchases. In theory, the Court could force the Bundesbank to stop bond purchases related to the ECB QE programs. Central Bank independence, usually defended by German authorities, will eventually prevail so that the ruling may indeed have little bearing on Christine Lagarde's policy stance. But the decision certainly adds to the current tensions within European institutions. Talks of a EU-sponsored recovery fund have been postponed. Peripheral spreads have also moved in response to the ruling.

In bond markets, Bund yields remain below the -0.50% mark after the ECB decided to cut interest rates on TLTRO-III loans (to as low as -1%). Demand estimates for the June 2021 refinancing operations are anywhere between €700b and €1.2T. Liquidity injections will be partly be used to fund carry trades on bonds with maturities within 3 years. Hence short-dated sovereign spreads may narrow in the months to come. Furthermore, the four main rating agencies have now updated their agencies on Italy. Fitch cut its rating to BBB-, whilst Moody's, S&P and DBRS left theirs unchanged despite downside risks. The spread on 10y BTPs came down from a peak near 250bp to 238bp at last week's close. As concerns credit, short-term swap spreads widened triggering modest underperformance of European investment grade credit. The deluge of corporate bond issuance in the US since the beginning of March likely lure capital away from European credit markets. Average spread over respective risk-free bonds hover about 200bp on both sides of the Atlantic.

In the US, investors are now speculating on possible Fed Funds rate cuts into negative territory. The Treasury's quarterly refunding includes borrowing needs to the tune of $3T in the second quarter alone. The announcement sparked steepening pressure (in 5s30s notably), initially via an upshift in back-end yields then through lower short yields as markets began to price in negative rates. Two-year yields moved closer to the Fed's repo rate (0.10%). The size of bond auctions has been increased on all maturities. Issuance of new 20-year benchmark will significant raise the amount of duration (i.e. interest rate risk) sold to the market, hence the upward pressure on long-term yields

The US equity market looks extremely resilient. A New York Fed study of quarterly earnings conference calls nevertheless reported that 45% of companies will cut investment spending and about a third of corporations will reduce payouts to shareholders. Still, the S&P 500 gauge is trading higher at 2930 points, 30% off March 23rd lows. Speculative positioning remains very short, which does limit downside risk in the near term. That said, the index is dominated by the GAFAM group, which makes up 20% of the index market capitalization. The equal-weight S&P 500 trails the market-cap based index by 7.5% year-to-date. This helps to explain the apparent disconnect between the financial performance and the underlying economy. In Europe, firms focus on balance sheet strength at the expense of investment spending. Earnings dropped by 25% in the first quarter. Health care is the only sector to record sales growth of more than 4% from a year ago.

Main Market Indicators

G4 Government Bonds	11-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.76 %	-1	-14	-16
EUR Bunds 10y	-0.51%	+5	-17	-33
EUR Bunds 2s10s	25 bp	+6	-3	-17
USD Treasuries 2y	0.16 %	-3	-7	-141
USD Treasuries 10y	0.7 %	+7	-2	-122
USD Treasuries 2s10s	54 bp	+9	+5	+19
GBP Gilt 10y	0.26 %	+3	-4	-56
JPY JGB 10y	0.01 %	+3	-1	+2
€ Sovereign Spreads (10y)	**11-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	50 bp	-1	+4	+19
Italy	234 bp	+1	+40	+74
Spain	132 bp	0	+19	+67
Inflation Break-evens (10y)	**11-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	30 bp	-2	-6	-
USD TIPS	112 bp	+4	-12	-67
GBP Gilt Index-Linked	281 bp	+6	-6	-30
EUR Credit Indices	**11-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	192 bp	+6	-37	+99
EUR Agencies OAS	75 bp	+3	+1	+31
EUR Securitized - Covered OAS	67 bp	+0	+3	+26
EUR Pan-European High Yield OAS	670 bp	+11	-81	+366
EUR/USD CDS Indices 5y	**11-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	83 bp	-3	+4	+39
iTraxx Crossover	496 bp	-25	+32	+289
CDX IG	91 bp	+0	+5	+46
CDX High Yield	631 bp	-30	+48	+351
Emerging Markets	**11-May-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	583 bp	-25	-42	+293
Currencies	**11-May-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.083	-0.61	-0.77	-3.53
GBP/USD	$1.239	-0.38	-1.06	-6.61
USD/JPY	¥107.2	-0.35	+0.35	+1.29
Commodity Futures	**11-May-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$30.4	$3.2	-$3.7	-$33.0
Gold	$1 706.5	$0.1	-$7.6	$183.7
Equity Market Indices	**11-May-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	2 930	3.50	5.02	-9.32
EuroStoxx 50	2 924	3.82	1.08	-21.93
CAC 40	4 564	4.24	1.27	-23.65
Nikkei 225	20 391	3.13	4.58	-13.81
Shanghai Composite	2 895	2.56	3.51	-5.09
VIX - Implied Volatility Index	28.28	-21.38	-32.13	105.23

Source: Bloomberg, Ostrum Asset Management

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