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STRATEGY WEEKLY

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Bubbles : the pitfalls of monetary easing

Key Points

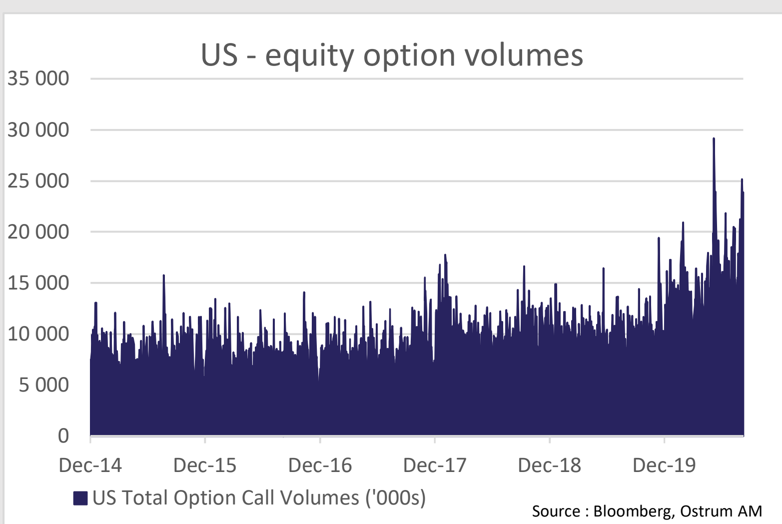
- **The ECB reacts to euro appreciation**
- **Sharp drawdown in Nasdaq**
- **Volatile US yields make a round trip to 0.70%**
- **Sovereign spreads unchanged in spite of heavy issuance**

ECB chief economist Philip Lane reminded market participants that the euro exchange rate "mattered" as the single currency breached $1.20. ECB talk triggered unwinding of long positions on the euro causing a pullback to $1.18 whilst reversing US curve steepening. The dollar regained ground against most currencies. In terms, Bund yields fell back to -0.45%. After a drop to 0.65% area, T-note yields closed last week above 0.70%.

Nasdaq dropped sharply intraday on both Thursday and Friday. The weakness in the Tech-heavy index did not spark widespread risk aversion but it does highlight the speculative nature of the summer rally. European markets have resisted, especially the battered bank sector in response to consolidation efforts in Spain.

Sovereign spreads (Italy 10-year near 150bp) have absorbed heavy bond supply last week. Credit spreads were unchanged last week (115bp against Bunds). High yield tightened despite wider synthetic spreads in the wake of the implied volatility's rise.

Chart of the week



The Nasdaq rally in the midst of a recession was likely fueled by several factors. Fed liquidity injections swiftly dampened selling pressure in March. In addition, the swift development of trading platforms enabled lots of individual investors to gain access to equity derivative markets and then a reduction in option trading costs further amplified call volumes, notably on technology names. The underlying buying tide may also have to do with the presence of a Japanese 'whale', which could engineer a sharp drawdown if it pulled out of the market.

The fragilities of the US labor market

Monthly employment data in the US are consistent with further improvement in the economic situation as shown in activity surveys. Data releases nevertheless point to fragilities in the labor market. The household survey revealed a sharp decline in the unemployment rate to 8.4% of the labor force thanks to a “declared” drop in unemployment of 3.7mn in August. Yet, the fall in unemployment mostly relates to the return to work of workers after temporary layoffs. The number of jobs permanently lost due to corporate restructuring or bankruptcies is rising much more rapidly than in the last two US recessions. Permanent job losses represent 2.12% of the labor force. In general, these job losses show up towards the end of recessions. The non-farm payroll data indicate a gain of just 1mn private-sector jobs in August. Public employment rose temporarily reflecting the census survey every 10 years. Meanwhile, many local authorities face financial difficulties which suggests that public-sector layoffs will increase in the months ahead. Thus, current growth pickup remains insufficient to kick-start the US job machine. This is highly important given the risks weighing on household finances. Without an agreement on fiscal stimulus, household disposable income may decline shortly. Unintentional savings during the lockdown period will help to smooth OUT consumption for a time but signs of bank credit rationing may slow spending going forward. Credit standards on credit cards, auto loans, mortgages and corporate loans have tightened in the third quarter. Monetary and fiscal impulse helped to assuage liquidity problems early on. However, strong growth will be badly needed to tackle the steady increase in corporate insolvencies. The end of the debt and eviction moratorium will also put household finances to the test.

ECB jawboning the euro

Last week in financial markets saw the euro rise above the $1.20 threshold. ECB chief economist Philip Lane intervened recalling market participants that the exchange rate “mattered”. The single currency traded down to $1.18 shortly after the comments. Currency appreciation amid near-zero inflation in the euro area is unwelcome for future price developments. Christine Lagarde’s message next Thursday after the governing council will likely echo Lane’s comments. The policy stance is unlikely to change, even though the ECB still has the possibility to sweeten TLTRO-III terms or prolong asset purchase programs.

In all likelihood, bond yields will remain low despite upward pressure stemming from increased issuance of long-term US Treasury bonds and fiscal policy uncertainty on the other side of the Atlantic. The may fan further steepening pressure in the US and foster outperformance of TIPS, as inflation-linked bond auction sizes have not been increased. Turmoil in equity markets have pushed German Bund yields lower again (-0.46%) with flatter 2s10s spreads (23bp). Bund yields trade within a wide -0.55% / -0.37% range. Germany also launched its inaugural green bond (0% August 2030) priced off its mirror conventional Bund which will facilitate the reading of the green premium. The German debt agency hence borrowed €6.5b talking advantage of significant investor demand worth €33b. The Green Bund is now trading 2bp below its benchmark. Long-date bond auctions in France and Spain have been well received by markets before Nasdaq nosedived on Thursday afternoon in Europe. Going forward, EU bond issuance linked to the SURE program will compete for capital with core sovereign bonds.

Is the tech bubble about to burst?

Nasdaq underwent two intraday drawdown on Thursday and Friday. The equity correction however limited in comparison to the summer rally reveals the extreme concentration in US stock performances in 2020. The reach for growth and lower bond yields are frequent explanations for multiple expansion but the equity uptrend undeniably reflect speculative developments. The year-over-year increase in earnings in the technology sector is… zero. In turn, call option volumes in US markets have exploded. Furthermore, according to FT report, a Nasdaq ‘whale’ out of Japan has accumulated very significant positions on technology stocks in the past few months. The concentration of US market performance is such that equal-weighted European indices are ahead of comparable US indices so far this year.

The Nasdaq downshift only had had a limited impact on other asset classes. The market correction is a Tech-centric phenomenon which may argue for sectoral rotation over time. Credit spreads in euro and dollar alike barely budged last week. Primary market issuance was nevertheless quite significant in late august in the US and new bond sales are set to increase in Europe through September. Spreads on financial subordinated bonds have been tightening and European high yield performed well. Yet CDS indices did react to rising implied volatility (VIX above 30%) spurred by the above-mentioned call option volumes.

In European stock markets, the banking sector recated positively to hopes for consolidation in Spain. Furthermore, news of a Covid vaccine to be distributed from early November has buoyed cyclical sectors including transport and leisure.

Main Market Indicators

G4 Government Bonds	07-Sep-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.7 %	-5	-2	-10
EUR Bunds 10y	-0.46%	-6	+5	-28
EUR Bunds 2s10s	24 bp	-2	+7	-18
USD Treasuries 2y	0.14 %	+1	+1	-143
USD Treasuries 10y	0.72 %	+1	+15	-120
USD Treasuries 2s10s	58 bp	+0	+14	+23
GBP Gilt 10y	0.25 %	-6	+11	-57
JPY JGB 10y	0.05 %	0	+4	+6
€ Sovereign Spreads (10y)	07-Sep-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	30 bp	0	+0	-1
Italy	151 bp	+2	+8	-9
Spain	81 bp	+1	+3	+16
Inflation Break-evens (10y)	07-Sep-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	50 bp	-11	-11	-
USD TIPS	170 bp	-10	+8	-8
GBP Gilt Index-Linked	315 bp	+1	+14	+4
EUR Credit Indices	07-Sep-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	115 bp	+1	-12	+22
EUR Agencies OAS	48 bp	+1	-4	+4
EUR Securitized - Covered OAS	36 bp	+0	-5	-5
EUR Pan-European High Yield OAS	442 bp	-9	-43	+138
EUR/USD CDS Indices 5y	07-Sep-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	53 bp	-1	-1	+9
iTraxx Crossover	324 bp	+2	-19	+117
CDX IG	67 bp	+1	+3	+22
CDX High Yield	366 bp	-2	-19	+86
Emerging Markets	07-Sep-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	409 bp	-10	-26	+119
Currencies	07-Sep-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.182	-1.03	+0.29	+5.27
GBP/USD	$1.316	-1.61	+0.85	-0.75
USD/JPY	¥106.27	-0.42	-0.33	+2.17
Commodity Futures	07-Sep-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$42.2	-$3.1	-$2.6	-$19.4
Gold	$1 928.9	-$43.0	-$106.7	$406.1
Equity Market Indices	07-Sep-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	3 427	-2.31	2.26	6.07
EuroStoxx 50	3 314	1.33	1.95	-11.46
CAC 40	5 058	2.24	3.45	-15.39
Nikkei 225	23 090	-0.22	3.40	-2.40
Shanghai Composite	3 293	-3.04	-1.83	7.95
VIX - Implied Volatility Index	30.75	33.93	38.45	123.15

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