MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

N° 030 // **July 5, 2021**

Topic of the week: The bipartisan infrastructure agreement

- **This bipartisan agreement marks an important step for Joe Biden**
- **Democrats prepare a reconciliation process incorporating larger measures, like the plan for American families, to pass them without Republicans**
- **Their financing and their vote are subject to many uncertainties**
- **This measures could lead the Fed to slowdown its tapering in 2022 and keep the size of its balance sheet at a very high level over the next few years**

Market review: The recovery continues

- **US job growth at 850k in June;**
- **Renewed flattening pressure in US Treasury markets;**
- **US equity gauges at record highs;**
- **High yield spreads tighten despite heavy supply.**

Chart of the week

The Bank of Italy issued a 2-euro commemorative coin to thank healthcare workers for all their work in dealing with the coronavirus epidemic.

Italy was the first developed country to be affected by the pandemic in February 2020 and one of the hardest hit. After the UK, Italy has the highest number of deaths in Europe from Covid since the start of the health crisis.

Figure of the week

100

Source: OECD

One hundred years of the Chinese Communist Party in a pivotal period: rapid aging, high debt, international tensions against it that risked making China old before it was rich.

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● Topic of the week

The bipartisan infrastructure deal

Joe Biden announced on June 24 that he had reached an agreement on a $ 1.2 trillion infrastructure plan with a group of Republican and Democratic senators. If it turns out to be on a smaller scale than the $ 2.3 trillion proposal announced last March, it marks an important milestone. Uncertainty hangs over its vote by Congress, all the more so as Nancy Pelosi, the President of the House of Representatives, wishes to make it conditional on the vote of a much larger plan that would include in particular measures of the plan for American families and the fight against global warming.

What's in the agreement?

After talks with the Republicans failed and weeks of negotiations with a group of 10 Republican and Democratic senators, an agreement was reached on June 24 on an infrastructure investment plan. It covers an amount of $ 1,200 billion over 8 years ($ 973 billion over 5 years) and includes $ 579 billion in new expenditure. The remaining amount relates to expected spending if current investment programs continue. They must be re-authorized on October 1.

$ 312 billion will be spent on transport, including roads, bridges, airports and ports, and $ 266 billion will be spent on other infrastructure such as high-speed internet and the water supply system.

Bipartisan infrastructures framework

Amounts in billions of $

Transports	**312**
Roads, bridges, major projects	109
Safety	11
Public transit	49
Passenger and Freight Rail	66
Electric vehicule infrastructure	7.5
Electric buses/transit	7.5
Reconnecting communities	1
Airports	25
Ports and Waterways	16
Infrastructure financing	20
Others infrastructures	**266**
Water infrastructure	55
Broadband infrastructure	65
Environnemental remediation	21
Power infrastructure	73
Wester water storage	5
Resilience	47
Total	**579**

Sources : White House, Ostrum AM

We are far from Joe Biden's initial proposal, announced last March, for an amount of $ 2,300 billion over 8 years concerning, in addition to so-called “physical” infrastructures, much more substantial investments to fight against global warming as well as more “social” infrastructures such as those aimed at improving access to home care for the elderly in particular. This bipartisan agreement remains an important step for the President, for two reasons. It represents an unprecedented amount of federal investment in transit and the largest in passenger rail since Amtrak (1971). It also includes investments intended to widely deploy charging stations for electric cars as well as the extension of high-speed internet throughout the country. In addition, Joe Biden wanted part of his proposals to be adopted by both camps in order to demonstrate that "American democracy works" and thus help to reconcile the two Americas as he had promised during his electoral campaign.

Its funding

Compromises were necessary to reach this agreement and more particularly on the method of financing in order not to increase the public deficit. Republicans opposed a corporate tax hike, as mentioned in the original proposal, and Democrats refused to index the tax on the price of gasoline to inflation. This went against Joe Biden's promise not to raise taxes on households earning less than $ 400,000 a year.

If this agreement makes it possible not to cross the red lines of each of the two parties, the actual financing of these investments remains unclear due to the lack of detail given by the White House. It indicates that the latter will operate in particular through a strengthening of controls in order to reduce tax evasion, a reallocation of funds already released and not used to deal with the coronavirus crisis, the sale of strategic oil reserves, public-private sector partnerships and the macroeconomic impact of infrastructure investments.

Uncertainty about his vote by Congress

This bipartite agreement has yet to be approved by Congress. However, it is not certain at this stage that the latter can be voted on by the Senate, where the Democrats have a narrow majority. In his announcement, Joe Biden said he would not sign it without being presented with broader legislation including the plan for American families as well as other priorities, like clean energy. Some Republicans took this statement as a threat of veto by the President over the barely reached deal. Joe Biden quickly backed down days later by declaring that he would not veto it while insisting that he had never hidden his desire to reach a bipartisan infrastructure deal while seeking to pass broader measures, with the sole vote of the Democrats, via a budgetary reconciliation procedure.

Nancy Pelosi, President of the House of Representatives, for her part, continues to condition the House's vote on the bipartite agreement on that on the second part of the measures announced by Joe Biden last April. It is therefore not certain that this agreement will be passed by Congress. Some Democrats see it as far too small compared to the original proposal, and Republicans don't want it to result in a vote on a much larger plan with potential corporate tax hikes. The government wants to quickly move forward on the bipartite agreement with a vote by the end of July, especially since the Republicans could seize the reinstatement of the debt ceiling from August 1 in order to obtain concessions from them.

Vote on an infrastructure law by the House of Representatives

On July the 1st, the House of Representatives passed an infrastructure bill worth $ 715 billion over 5 years. It seeks to re-authorize federal infrastructure programs that would otherwise have expired on October 1. It relates in particular to transport (roads, railways and bridges) and the supply of drinking water as well as measures against global warming. Only 2 Republicans gave their support. This law will serve as the basis for discussions on the infrastructure plan with the Senate and represents a step forward by the Biden administration on the bipartisan plan.

Towards a reconciliation procedure for larger measures

Via the budget reconciliation procedure, bills can be voted on in the Senate by simple majority unlike other bills which require 60 votes to avoid obstruction. Democrats have a narrow majority in the Senate, which would allow them to push through a much larger plan without needing a Republican vote. It would include measures that were not factored into the infrastructure plan as well as the plan for American families. No specific amount has yet been put forward.

Measures to combat global warming

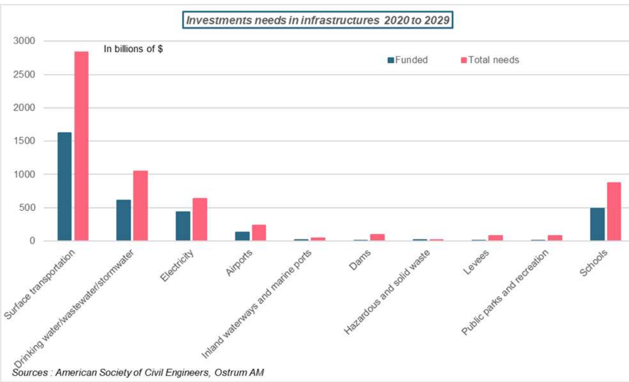
This would concern in particular the measures which were withdrawn from the initial infrastructure plan and which Joe Biden made one of his priorities in order to achieve carbon neutrality by 2050. This notably involves including measures aimed at to establish clean electricity standards intended to decarbonise the American electricity sector by 2035, responsible for a quarter of greenhouse gas emissions in the United States. It would also include tax cuts for investments in renewables and electric cars. The initial plan also included more social measures aimed in particular at improving access to home care for the elderly. These measures would be financed through an increase in corporate taxes.

The plan for American families

Democrats also want to take measures included in the plan for American families, presented last April, which then amounted to a total of $ 1.8 trillion. They aim to reduce inequalities and poverty through, in particular, an extension of health coverage, free access to university, generalization of access to nursery school and an extension of tax credits for families with children. This plan would be financed by a tax hike on the wealthiest households.

Why a massive plan for infrastructure?

Most of the infrastructures were built between the 1950s and 1970s and the investments required for their renovation or replacement turned out to be very insufficient, which results in aging infrastructures or even at the end of their life. Every 4 years, the American Society of Civil Engineers publishes a report on the quality of infrastructure, the rating ranging from A to F. For 20 years, the rating has been around D and for the first time, in 2021, it was upgraded to C- versus D + in 2017. Progress has certainly been made but it is still largely insufficient, the score attesting the poor quality of the infrastructures, some of which are at risk. Schools are rated D +, roads D and public transport D-. This same body also estimates the amount of investment needed over 10 years to keep the infrastructure in good condition and achieve a B rating. The difference between the amounts financed (based on the trajectory of current spending) and the estimated funding needs reveals an investment gap that continues to increase to $ 2.59 trillion over 10 years against 2.1 trillion estimated 4 years ago. The following graph shows the investments required until 2029 according to the 11 categories monitored.



By far, the largest investment gap comes from land transport (roads, highways, bridges) with an investment gap of $ 1.215 trillion. They are followed by the water supply network ($ 434 billion), schools (380 billion) and the electricity network (197 billion).

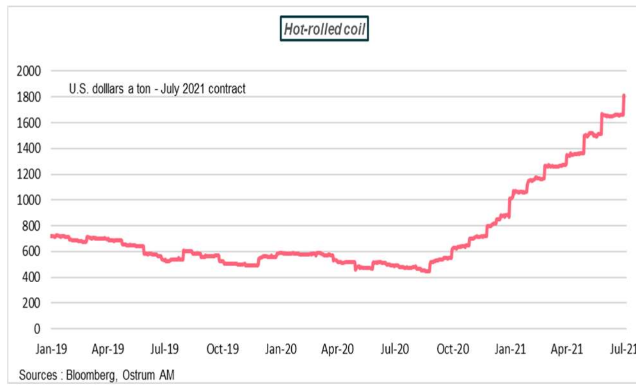
Not making the investments needed to renovate or replace these infrastructures obviously has an economic cost, but also a health and social cost. The American Society of Civil Engineers estimates that doing nothing would cost by 2039: $ 10 trillion in GDP, 3 million jobs and 2.4 trillion fewer exports. Traffic-related delays alone are estimated to cost $ 160 billion per year overall and for motorists: $ 1,000 per year in terms of wasted time and fuel. Power outages, like in Texas this year, cost $ 70 billion a year. The poor quality of the drinking water network and dilapidated schools obviously represent health risks. The poor condition of roads, public transport, schools, the drinking water network as well as the slowness of the Internet connection in some regions disproportionately affect the least advantaged people, thus widening social inequalities. That's why Joe Biden has put this infrastructure plan at the heart of his policy to boost growth, reduce inequality, create jobs and be better able to compete with China. The goal is to “build back better” in order to fight in particular against global warming.

Impact on markets

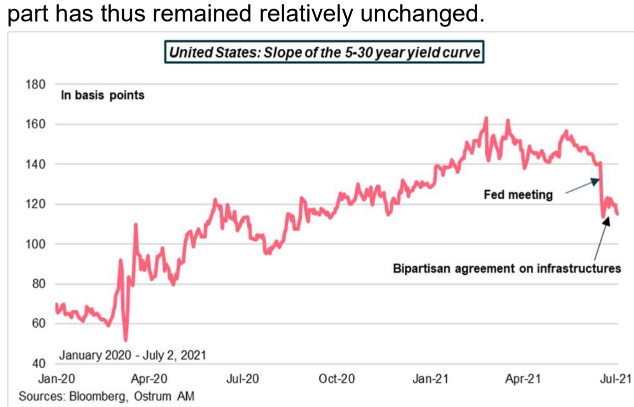
Little immediate impact

The announcement of the June 24 bipartite infrastructure deal had no impact on financial markets given the uncertainty over its vote by Congress and the wait for a proposal including broader action by the Democrats in an amount not yet known.

We were nevertheless able to observe a new rise, to a record level, in the price of iron coils which will indeed benefit from the effective implementation of this plan, in particular through greater demand for the construction of bridges, ports, airports ... The vote on the infrastructure plan will be likely to benefit construction equipment companies, those in the public service and certain industries such as electric recharging.



This deal, being for a smaller amount than Joe Biden's initial proposal, may also have helped keep rates low after the sharp flattening of the US yield curve observed following the Federal Reserve meeting of June 15 and 16. Market operators were reassured by the upward revision of key rate expectations by the members of the Fed in order to control inflationary pressures. The forecasts expect on average a hike in the Fed's key rates from 2023 and no longer 2024 as previously expected. After losing 27 basis points in the space of 3 days, the slope of the yield curve on the 5-30 year part has thus remained relatively unchanged.

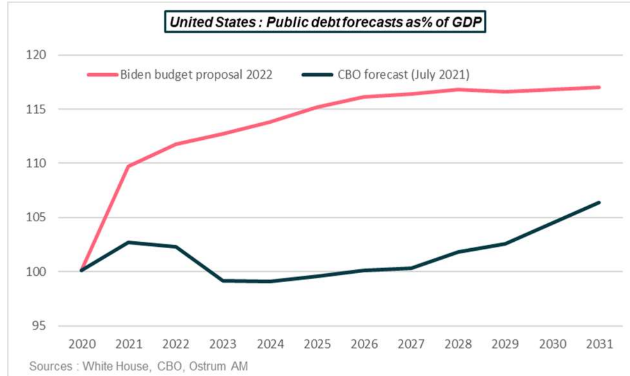


Stronger impacts to come

If progress is made during the summer as regards the vote on the infrastructure plan as well as the development of a broader proposal intended to be adopted by a procedure by reconciliation, tensions should operate on the long end of the yield curve due to anticipation of higher federal debt and larger government issues.

According to Joe Biden's budget proposal for 2022, forecasts show a sharp increase in federal public debt over the next 10 years. This reflects the fact that spending would take place over an 8-year period while the increase in revenue, linked to potential tax hikes on companies and wealthier households, would occur over a 15-year period. Public debt is thus expected to reach 117% of GDP in 2031, against 110% expected in 2021, a marked increase compared to CBO forecasts (Congressional Budget Office).

The latter expects a public debt of 106.4% of GDP in 2031. These forecasts are based on the policies actually adopted in early July and therefore do not include potential future measures. These would thus be such as to cause the Fed to retain a large size of its balance sheet in order to be able to absorb the additional issues of the federal government. In the shorter term, the public deficit expected in 2022 remains high: 7.8% of GDP, against 16.7% in 2021, according to the 2022 budget proposal. This could force the Fed to slow down its tapering (the reduction at a gradual pace of its asset purchases) next year since the market will not be able to absorb all of the government's debt issues.



Sources : White House, CBO, Ostrum AM

The bipartite infrastructure deal is an important step in delivering critical public investments to put the US economy on a higher and more sustainable growth path. The latter must be validated by Congress and the Democrats are preparing in parallel a reconciliation procedure in order to pass the rest of the measures presented by Joe Biden on the plan of families and the fight against global warming. There are many uncertainties as to the actual vote for these measures and how they are financed. The time lag between the period during which public investments are made (8 years) and that concerning the increase in revenue (15 years) will be such as to increase the level of public debt and encourage the Fed to maintain the size of its balance sheet at a very high level in the years to come.

Aline Goupil-Raguénès

Market review

The recovery continues

Bond yields unfazed by job US data, stock gauges at record highs

Economic data releases continue to paint a picture of sustained growth punctuated by inflationary pressures, most notably in the United States. Despite a stance that now appears less tolerant of price pressures, the Fed's current policy remains quite favorable to risky assets. US equity indices are thus setting daily records thanks to the inertia of bond yields, as T-note yields failed to stay near 1.50%. European bond yields are benefiting from the acceleration in PEPP purchases and the stabilization of inflation, while the euro dipped back to around $ 1.18. Despite the concerns related to the delta variant, the levels of volatility of equities, interest rates and even more so credit spreads remain very low and help foster carry trades.

The economic recovery continues in the United States. The ISM manufacturing index remains above 60, and activity is barely slowed by input prices at their highest for 50 years. The rise in housing prices stretches up to + 14% year over year, leading to weakening demand for residential investment. Christopher Waller, a member of the Board of the Fed, now suggests dialing down the Fed's support to the mortgage market. The employment issue remains central to monetary policy decisions. The US economy created a total of 850k jobs in June after 583k the month before. Job creation comes primarily from the leisure and hospitality sector (+ 343k), which was boosted by the lifting of health restriction measures. Despite a sharp recovery for just over a year, total employment is still 4.4% below February 2020 levels. The seasonal adjustment nevertheless masks an almost linear increase in employment of up to 1 million each month since February. In addition, the rise in the unemployment rate to 5.9% is based on the questionable estimate of a *loss* of 18k jobs as reported in the June household survey. It is unlikely that monetary policy will be changed on the sole basis of this indicator which was indeed broadly in line with expectations.

The European situation is similar. PMI surveys describe a sustained growth economy. While there are few short-term uncertainties, the delta variant poses a risk to the economies most exposed to tourism. Several countries have already closed their borders to British travelers. The epidemic situation should be monitored in Portugal in particular. Euro area inflation also moderated to 1.9% in June. The price index excluding volatile elements remains close to 1%. The prices of industrial goods barely reflect previous increases in commodity prices.

Fixed income markets have become unresponsive to solid economic publications as they come in line with expectations. The US 10-year yield even dipped after the employment statistic to 1.44%. Admittedly, the extended weekend for Independence Day limits the ability of market participants to take risks, but the significant flattening movement suggests that the collateral shortage has remained a crucial element of the bond market direction since mid-March. The use of the Fed's reverse repo facility now exceeds 1 trillion. The ability of the market to absorb these securities entails an important piece of information for the Fed before embarking on a gradual reduction in its asset purchases. The excess liquidity is such that the market prefers to return cash to the Federal Reserve.

In the euro zone, the EU raised a total of € 15 billion over two tranches at 5 and 30 years, which once again met with great success with investors. The EU has now borrowed 35 of the 80 billion expected this year. More issues (7 years, 20 years or 15 years) are expected in July. The ECB support is also enabling the increase in bond issuance by further accelerating its weekly purchases to € 24 billion last week. Sovereign bond auctions were also heavy last week, in France and Spain notably. The 20-year OATs attracted less demand than expected, perhaps due to the expectation of a higher-yielding 30-year new benchmark soon. The total amount raised in Spanish Bono sales, at the bottom of the announced range, seem to support the thesis of an upcoming reduction in the 2021 financing program and helped narrow spreads below 60bp on the 10-year maturity. Overall, duration demand was high around the half-year close as spreads tightened including in Greece.

Credit spreads show little volatility on the secondary markets. The delta variant does not seem to have impacted market trading, resulting in weekly tightening of 1bp in the euro area, 2bp in the United States. There is some widening pressure on hybrids and subordinated debt after a month of clear outperformance. Maturities of less than 5 years remain difficult to find, apart from a few rare issues in this segment. In the first half of the year, financial bond issues net of redemptions were much higher than in 2020. On the other hand, non-financial obligations after considering CSPP purchases and maturities leaves a free float up to € 5bn. In this context, the high price of the market does not argue against overexposure in credit. The compression of high yield spreads continues. The premium on B bonds seems insufficient and calls for reallocations to the BB group. The 1H 2021 primary issuance (€ 58bn in net terms) is already approaching the record annual total of 2020. The overweight positioning of high yield in IG credit funds seems to offset the outflows from high yield funds.

US stocks are setting all-time highs ahead of a promising earnings season. The major European indices lost around 1% last week.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	05-Jul-21	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.66 %	-1	+1	+4
EUR Bunds 10y	-0.21%	-2	+0	+36
EUR Bunds 2s10s	45 bp	-1	-1	+32
USD Treasuries 2y	0.23 %	-2	+9	+11
USD Treasuries 10y	1.42 %	-5	-13	+51
USD Treasuries 2s10s	119 bp	-3	-22	+40
GBP Gilt 10y	0.71 %	-1	-8	+52
JPY JGB 10y	0.04 %	-2	-5	+2
€ Sovereign Spreads (10y)	**05-Jul-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	33 bp	-1	-4	+10
Italy	102 bp	-5	-7	-10
Spain	61 bp	-2	-6	-1
Inflation Break-evens (10y)	**05-Jul-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	138 bp	+5	+1	-
USD TIPS	234 bp	+0	-8	+35
GBP Gilt Index-Linked	348 bp	-1	-12	+48
EUR Credit Indices	**05-Jul-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	83 bp	+0	-2	-9
EUR Agencies OAS	41 bp	+0	+2	+0
EUR Securitized - Covered OAS	33 bp	+1	+3	+1
EUR Pan-European High Yield OAS	294 bp	-12	+1	-64
EUR/USD CDS Indices 5y	**05-Jul-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	46 bp	-1	-4	-2
iTraxx Crossover	227 bp	-3	-17	-15
CDX IG	47 bp	-1	-3	-3
CDX High Yield	269 bp	-4	-14	-24
Emerging Markets	**05-Jul-21**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	344 bp	+11	+14	-7
Currencies	**05-Jul-21**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.187	-0.49	-2.65	-2.86
GBP/USD	$1.385	-0.22	-2.33	+1.33
USD/JPY	¥110.9	-0.24	-1.49	-6.9
Commodity Futures	**05-Jul-21**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$76.9	$2.8	$5.5	$25.7
Gold	$1 791.9	$13.4	-$107.4	-$106.5
Equity Market Indices	**05-Jul-21**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	4 352	1.67	2.89	15.87
EuroStoxx 50	4 087	-0.06	-0.05	15.05
CAC 40	6 568	0.15	0.80	18.30
Nikkei 225	28 598	-1.55	-1.19	4.20
Shanghai Composite	3 534	-2.00	-1.60	1.76
VIX - Implied Volatility Index	15.07	-3.52	-8.22	-33.76

Source: Bloomberg, Ostrum Asset Management

Additional notes

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