MyStratWeekly
Market views and strategy

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N° 056 // **February 7, 2022**

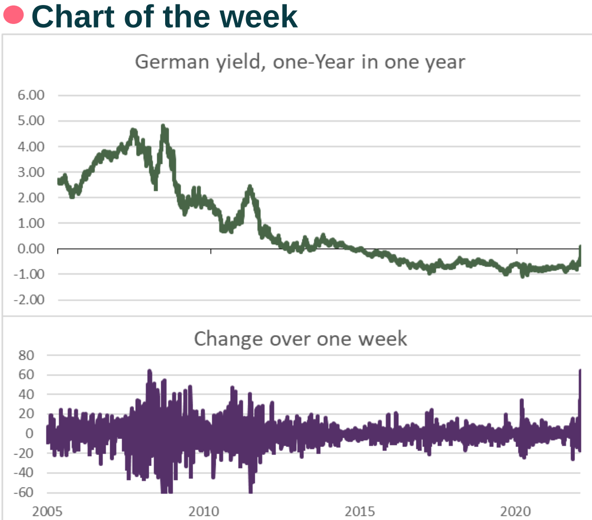
Topic of the week: How far the Fed?

- **The market has gone from one extreme to the other in 6 months and now expects a large-scale monetary tightening during the year;**
- **Economic data is undoubtedly pushing in this direction, with a Fed that is clearly far behind the cycle;**
- **On the other hand, it is not at all certain that risky assets can absorb such a turn and in this case, tightening incentives could quickly run out, especially if the shares deviate. The "put of the Fed" is not dead.**

Market review: ECB catching up with reality

- **ECB no longer ruling out higher rates in 2022;**
- **Euro bounces, Bund yields near +0.2%;**
- **Peripheral spreads widen, uncertainty on asset purchases;**
- **Growth stocks underperform, high yield under pressure**

Chart of the week



Last Thursday's ECB press conference left its mark, particularly on the short part of the curve. The German rate at 1 year in 1 year ended the week at 0.10%. This is 64 bps higher than a week earlier. A movement "with more than 5 sigma", so extremely rare.

Expectations of increases in the ECB's key interest rates have therefore changed considerably. Cf. Market Review for more details.

Figure of the week

3%

The proportion of the Euro credit IG index that has negative yield.
That proportion was 49% in August last year.

Source : Ostrum AM

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● Topic of the week

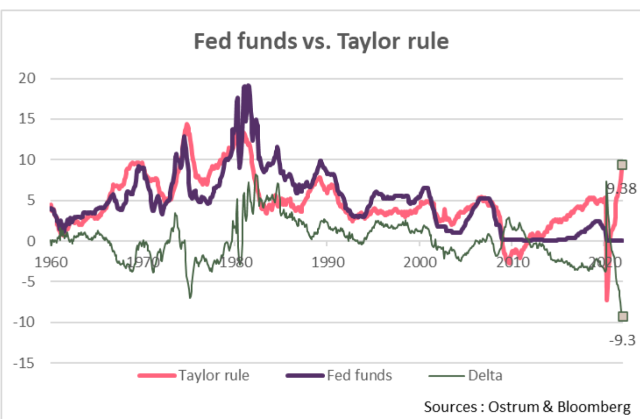
How far the Fed?

The market has completely changed its mind in 6 months and now expects a large-scale monetary tightening during the year. Economic data is undoubtedly pushing in this direction, with a Fed that is clearly far behind the cycle. On the other hand, it is not at all certain that risky assets can absorb such a turn and in this case, tightening incentives could quickly run out, especially if the shares deviate. The "put of the Fed" is not dead.

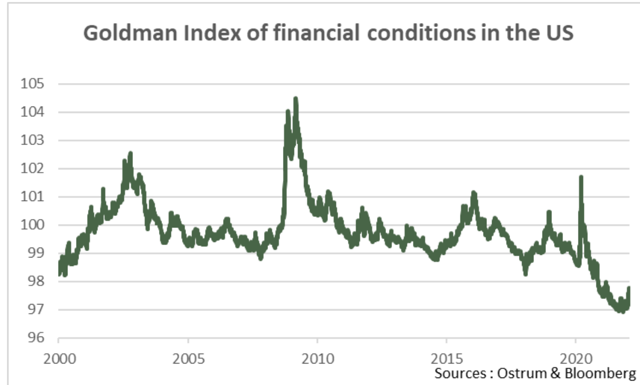
Extremely favourable monetary conditions

Let's start with an appraisal of the current situation. Inflation is at 7%, unemployment is below 4%, The Case-Shiller (house prices) is over 18% and Fed funds at 0%.
One of those numbers is wrong.

In fact, a Taylor rule suggests that the Fed funds should currently be at 9.4%. This is the largest spread to actual rate ever observed, by far.



A more comprehensive approach gives a similar message. For example, the Goldman Sachs Financial Conditions Index, which includes interest rates, credit and equities, remains in spite of recent market stalling at very favorable levels.

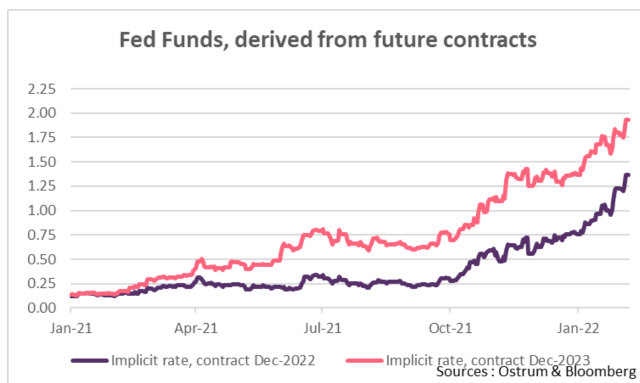


As the economy shows more and more signs of overheating, so monetary policy is still calibrated for an acute crisis like the one we experienced during the Covid wave. This calibration is inappropriate.

A pendulum swing

While the markets seemed extremely complacent to us until a few months ago, there is now a bidding war on the Fed's speed of monetary tightening.

The chart below illustrates this change in attitude. In September of last year the market told us that the Fed would raise its rates once in 2022. And again, this was not quite certain. We are now at 5 rate hikes with Fed funds ending the year at 1.25%.

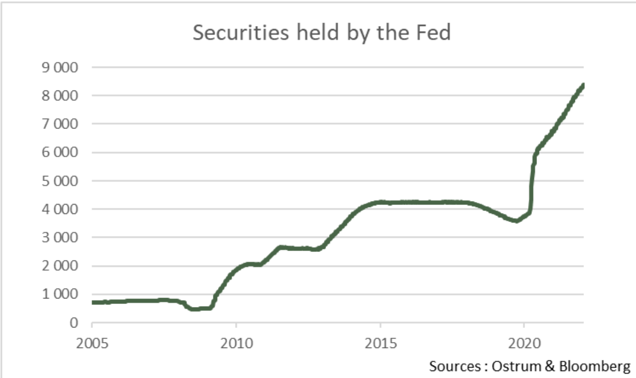


This change has been accompanied by a considerable dispersion of expectations among forecasting institutes. If there is a majority of expectations with 4 or 5 increases, the pallet ranges from 3 to 7 increases (one at each FOMC starting in March).

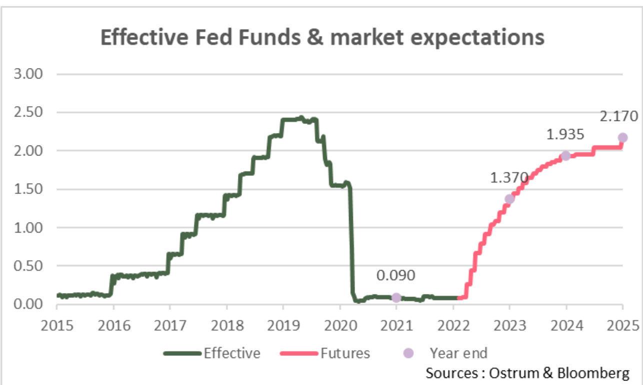
The central scenario

The central scenario on the Fed, if we read the market would be in three points:

A tapering that leads to a stop of QE in March. The Fed has communicated so much on the subject that the case is almost heard. March is tomorrow, a Fed reversal is unlikely.



Rate hikes. The first increase in March, which was also widely communicated by the Fed. Future contracts are consistent with five rate increases.



A quantitative tightening (reduction in the size of the balance sheet) which would start in June. At the last press conference, Powell told us, "I would say we're going to have another discussion at the next meeting, and I guess we'll at least have another discussion at the next meeting." The start of a decrease in the size of the balance sheet in June therefore seems to be the most likely hypothesis. A JP Morgan survey of its clients gave a large majority, over 60%, of respondents who were waiting for an implementation in June. The pace would then be 100 billion a month.

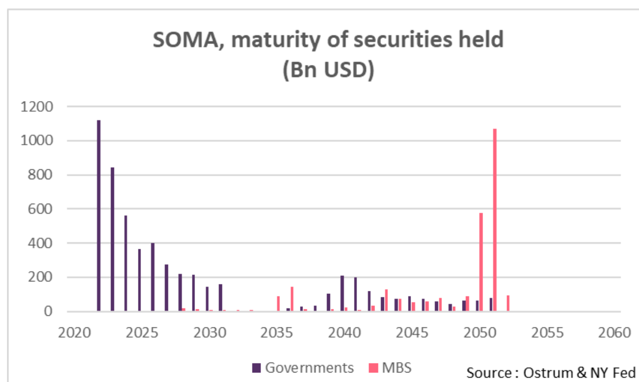
QT, technical problems

The Fed tried to reduce its balance sheet size between October 2017 and July 2019. Maturing securities, mainly treasury securities, did not result in redemptions (to a certain extent). As a result, the Fed's portfolio was gradually shrinking through attrition. The Fed had also been forced to retreat quickly because tensions on the market had quickly appeared.

However, the Fed should be faced with a portfolio composition problem this time around. The table below summarizes the SOMA (in Fed jargon, the "SOMA" for "System Open Market Account" is the Fed's account that contains the dollar assets acquired on the market).

Security Type	Total (USD Bn)	% of total
Bills	326.04	3.9%
NotesBonds	4 907.63	59.1%
FRNs	27.58	0.3%
TIPS	381.50	4.6%
Agency Debts	2.35	0.0%
CMBS	9.10	0.1%
MBS	2 651.72	31.9%
Total	**8 305.92**	**100.0%**

The important thing to remember is that there is a small third of SGM and two thirds of Treasury or equivalent in the portfolio.
And that's where the problem lies. We plunged with delight into the tens of thousands of Excel lines of the file "SOMA" to produce the following graph. It summarizes the fall of securities held by the Fed. The message is simple: SGMs have a very long maturity, at least 10 years, more than 30 years in their vast majority. If the Fed reduces its balance sheet through attrition, as it did in 2017-19, the vast majority of maturing securities will be Treasury. And so the Fed's portfolio will warp, with SMBs gradually increasing their relative weight.

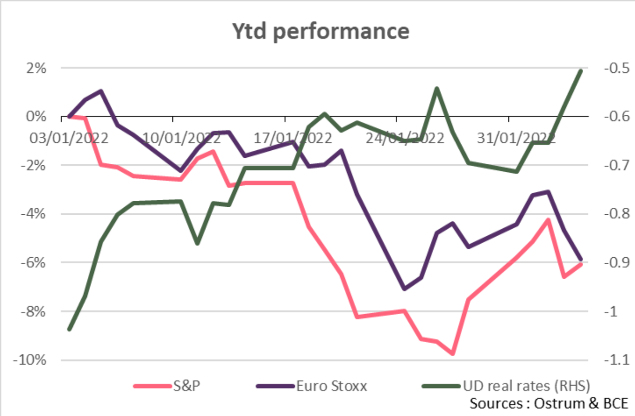


This is exactly the opposite of what the Fed wants to do.

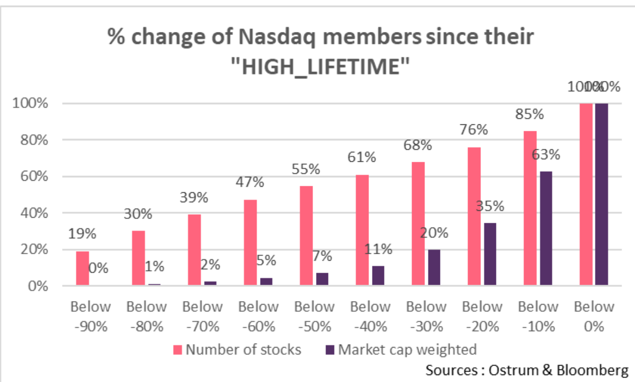
Moral of the story, the Fed will be forced to sell SGMs on the market. And this is potentially much more disruptive than just waiting for the titles to mature.

Fed put?

The real problem is not related to these technical arguments on the implementation of the QT. But rather the ability of the market to absorb what is a very strong return on the monetary stick. A small inventory shows that the sources of stress are already very high, while the Fed has not even taken the first step in terms of rate increases.

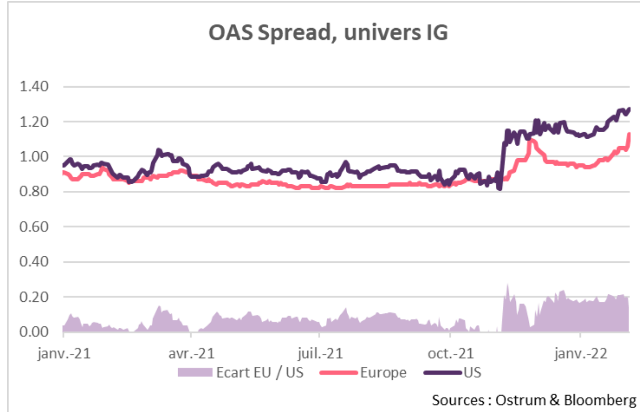


The chart above eloquently shows that volatility on the stock market this year is very much related to the level of US real rates, thus indirectly to expectations on Fed funds. It is interesting to note that Europe has been more resilient, which is unusual since in general the US markets serve as a refuge. Here too, the underperformance of the United States is an indication that the Fed's reversal is largely the explanatory factor.



Nasdaq also suffered tremendously. It experienced a drawdown of more than 15% at the beginning of the year. Which, given the high volatility of the index and the more than tense valuations, is ultimately not that violent. On the other hand, it is the composition that is impressive. As shown in the chart below, 55% of Nasdaq companies saw their prices halve, or more, from their historical highs. It doesn't really show up in the index, because it's mostly very small businesses that together represent less than 8% of the market capitalization. These statistics, however, show the extent of the correction, largely hidden by a few mega-caps that resisted better.

The same goes for credit returns that have diverged until the hawkish ECB's press conference Thursday. And here too more than they have done in Europe, which is another indication that the increase in the risk premium on assets is very much linked to the Fed.



What will happen after 5 rate hikes, as expected by the market, and a QT of 100 billion per month in the second half of the year? At a minimum, turbulence can be predicted. A significant correction on risky assets becomes very plausible. In this case, the market will (in part) be the work of the Fed, since a fall in the stock market or a widening of spreads will help to tighten financial conditions. The question then is how far the Fed will tolerate this. History shows that the Fed's sensitivity to these elements is very strong.

Conclusion: from one extreme to the other

We were very skeptical about market expectations 6 months ago. It seemed to underestimate the risks of inflation and therefore the Fed's potential for reversal. Of course, the Fed is far behind in terms of economic data. But we're just as skeptical right now, though the other way around, and the market seems to have moved far too quickly. The expected volume of monetary tightening is more than substantial and would inevitably be very damaging to risky assets. Where is the Fed's put? When will it report that it is stepping up? Hard to say, but the five rate hikes expected by the market, coupled with the $100 billion monthly QT over the second half of the year, seem to be a high bound of what is reasonably feasible, it is likely to do less.

Stéphane Déo

Market review

ECB catching up with reality

ECB no longer rules out raising rates in 2022, fireworks on bond markets

The tone of Christine Lagarde's press conference last Thursday is indicative of Council members' concerns about inflation. It looks like the Bank's restrictive turn will formally be announced in March with the updated economic forecasts. The overall picture is eloquent: inflation in the euro area is at an all-time high at 5.1% in January and the unemployment rate, at 7% in December, is at its lowest ever. Soaring energy prices push production costs higher and maintain widespread pressures on consumer prices. Hiring difficulties are worsening, which significantly alters the risk of more sustained wage inflation, which monetary policy must take into account. The euro is arguably undervalued. Fiscal policy has also decisively taken over from monetary stimulus. For all these reasons, the ECB's monetary toolkit (asset purchases, TLTROs, key interest rates, quantity of reserves exempt from negative rates) should be redesigned this summer. An abrupt end to the APP, which had sometimes been considered to be "permanent", would raise questions regarding in particular the bond proceed reinvestment policy and the "flexibility" required in the conduct of the ECB policy to contain asymmetric risks (peripheral sovereigns, credit BBB/BB…).

This is undoubtedly a major turning point for the markets. This decision also follows an interest rate hike in the UK. The BoE repo rose by 25bp and four of the nine MPC members were willing to increase it by 50bp. Four additional movements are planned for 2022 in parallel with the balance sheet reduction. Outright sales of Gilts will be needed to absorb excess cash, at a likely pace of £20bn each month from this summer. Finally, the RBA is taking a step towards monetary tightening by closing its asset purchase program. "Caution" will still prevail, but the latest change in the monetary stance makes the previously expected status quo until 2024 obsolete. Conversely, in the emerging world, the pace of monetary tightening is easing, in the wake of the PBoC which may continue easing.

Economic publications have therefore been eclipsed by central bank meetings and the spectacular earnings releases from big US technology companies (Meta downside surprise and then Amazon's upside surprise in particular). Omicron caused a loss of activity in the service sector in southern Europe, after hitting Germany in December. Job growth in the United States (+467k in January) surprised on the upside with annual revisions and a welcome increase in labor market participation (62.2%). The unemployment rate is at 4%, with an upbeat hourly wage gain.

The reaction of the financial markets is commensurate with the monetary surprise. Price action after the BoE and ECB wiped out the previous rally fueled by some $22bn of inflows into global equity funds (106bn YTD in the context of the sharp equity correction). The credit and high yield markets, on the other hand, recorded historic outflows.

The outlook for of rate hikes in the euro area is a game-changer for the single currency, which soared above $1.145. The dollar partially erased the geopolitical premium. It also led to a sharp rise in yields for maturities between 2 and 5 years. The 5-10 year spread has narrowed by nearly 15bp now since the start of the year. Yields on 10-year Bunds in positive territory pull other yields higher. JGB yields shot up to 0.20%. The US T-note broke above the 1.80% level after the ECB press conference and moved further towards 1.90%after the non-farm payroll data, thus making new 2022 highs. The announcement of the Treasury's quarterly refunding had been well welcomed with a uniform reduction in auctions across maturities. Issuance of inflation-linked bonds will nevertheless increase by 1 billion per month. Breakeven inflation rates plunged with the expected withdrawal of monetary stimulus despite oil prices at 7-year high at $93 a barrel of Brent. The announced increase in OPEC+ production (400kbpd) is proving difficult to implement given production constraints in Russia, Nigeria and Kazakhstan. Within the euro area bond markets, peripheral spreads traded erratically. The expected attrition of QE argues for a reduction in risky sovereign debt positions. The Italian 10-year BTP is trading above 150bp at the end of the week. Portuguese and Spanish bonds also widened. Greek bonds (186 bp at 10 years) are suffering from the uncertainty surrounding the future ECB reinvestment policy.

The credit market is also undergoing significant selling pressure. European credit spreads are up 11 bps in 2022. The widening in high yield spreads should continue under the influence of protection buying on the iTraxx Crossover index. The high volatility environment fostered Crossover spread which is now hovering about 300bp.

On the equity markets, sectoral and stylistic performance gaps have been significant since the beginning of the year. Extreme volatility (with intra-day movements of 4-5%) is fueled simultaneously by monetary tightening, the risk of conflict in Eastern Europe and uncertainty about corporate earnings prospects. On the European market, the growth factor and small and mid-cap stocks lost ground to 'value' equities. Stocks with high dividend payouts outperform at the expense of the quality factor. This rotation towards the value theme coincides with the rise in rates and higher returns to shareholders.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	07-Feb-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.28%	+25	+31	+34
EUR Bunds 10y	0.24%	+23	+28	+41
EUR Bunds 2s10s	51bp	-2	-4	+8
USD Treasuries 2y	1.31%	+13	+45	+58
USD Treasuries 10y	1.94%	+16	+17	+43
USD Treasuries 2s10s	62.3bp	+3	-27	-15
GBP Gilt 10y	1.42%	+12	+25	+45
JPY JGB 10y	0.2%	+2	-10	-6
€ Sovereign Spreads (10y)	**07-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	45.5bp	+4	+4	+8
Italy	162bp	+34	+34	+27
Spain	86.48bp	+13	+13	+12
Inflation Break-evens (10y)	**07-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2%	-10	+2	-10
USD 10y Inflation Swap	2.58%	-14	-12	-19
GBP 10y Inflation Swap	4.23%	-14	+4	+6
EUR Credit Indices	**07-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	113bp	+7	+19	+18
EUR Agencies OAS	53bp	+1	+6	+4
EUR Securitized - Covered OAS	50bp	0	+5	+4
EUR Pan-European High Yield OAS	368bp	+15	+59	+50
EUR/USD CDS Indices 5y	**07-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	66bp	+7	+16	+18
iTraxx Crossover	320bp	+33	+68	+78
CDX IG	65bp	+4	+12	+15
CDX High Yield	358bp	+14	+51	+65
Emerging Markets	**07-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	378bp	-11	+17	+9
Currencies	**07-Feb-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.145	1.896	0.775	0.7
GBP/USD	$1.353	0.632	-0.412	0.0
USD/JPY	JPY 115	0.061	0.452	0.0
Commodity Futures	**07-Feb-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$92.9	$3.7	$11.9	20.16
Gold	$1 815.9	$18.8	$19.4	-0.73
Equity Market Indices	**07-Feb-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 512	-0.08	-3.53	-5.3
EuroStoxx 50	4 127	-1.15	-4.16	-4.0
CAC 40	7 020	0.30	-2.76	-1.9
Nikkei 225	27 249	0.91	-4.32	-5.4
Shanghai Composite	3 430	-2.68	-4.19	-5.8
VIX - Implied Volatility Index	22.90	-7.77	22.07	33.0

Source: Bloomberg, Ostrum AM

Additional notes

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