MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 033 // **July 26, 2021**

Topic of the week: Why are US yields down?

- **Concerns about growth may explain some of the decline in US rates, but these arguments are hard to fully convince;**
- **The other aspect is the flow dynamics, with a very sharp decrease in issuances as the US Treasury consumes its liquidity to finance its deficit, which reduces its issuance needs;**
- **In addition, those liquidity inflate the demand from the financial sector. There is therefore a significant supply/demand imbalance on the US debt. This imbalance is temporary and should quickly disappear.**

The strategy team will cease publications during August. We will be back with a new MyStratWeekly in September.

Market review: *Citius, Altius, Fortius*

- **The Olympic motto seems to apply to US equity gauges;**
- **The ECB reviews its inflation target and its interest rate strategy;**
- **The S&P 500 close to 4,400 points;**
- **Bund yields dip below -0.40%, sovereign spreads well oriented.**

Chart of the week

Citi's earning revisions is close to all time high as the recovery continues to surprise on the upside pushing profits back towards pre crisis at a very rapid pace.

This is one fundamental support for the equity market that explains the resilience of stock indices. The current reporting season seems to start very well and could fuel this trend even more.

Figure of the week

-10.6

Source : Ostrum AM

The percentage decline in the participation rate of people aged 65 or more.
The decline in each other cohorts is less than 2.;7%.
We doubt this 65+ will come back to the labor force.

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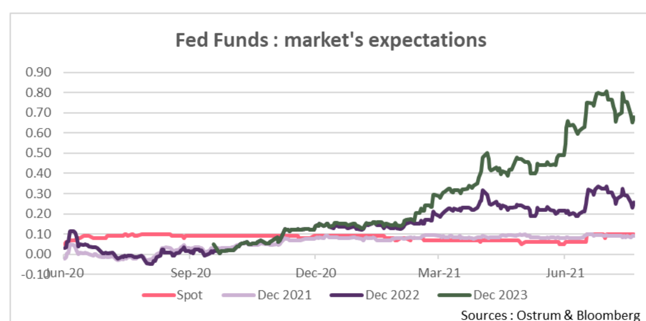
● **Topic of the week**

Why are US yields down?

The decline in US rates has prompted a number of explanations... and a lot of comments. While it seems difficult to justify the decrease solely by the fundamentals, technical elements seem important. This paper looks in detail at the flows on the Treasuries market with supply and demand developments of unprecedented magnitude. It seems very likely to us that these factors account for a large part of the decline in rates.

Fundamentals?

The decline in long-term rates, but also the flattening of the US curve, are usually signs of growth waning. Recent trends in interest rates therefore raise the question of a sign of slowing growth. Long-term rates fell from 1.75% in early April to less than 1.20% last week. In addition, expectations of Fed rate increases have also been reduced as shown in the chart below. While the market was anticipating an increase in rates next year, it now attaches a probability of only 50% to an increase and while it expected three increases by the end of 2023, it is now expecting only two.



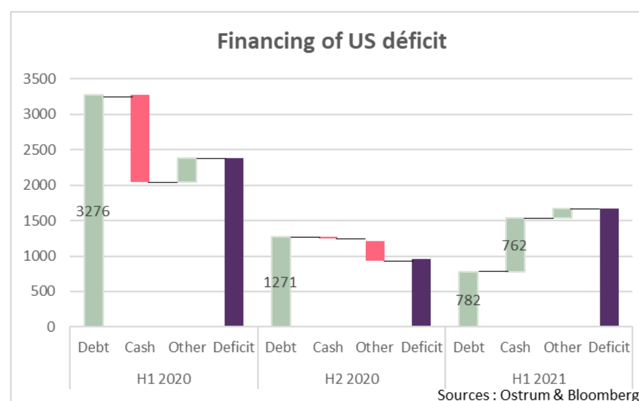
While concerns about growth sustainability have undoubtedly played a role, it seems difficult to attribute all of this decline to fundamentals alone. Growth is slowing down, but after stratospheric figures (US GDP +33.4% in Q3 last year), a slowdown is inevitable and anything but unexpected. The consensus of economists has remained stable recently with revisions rather upwards over the past quarter. Surprises remain positive, which shows that there is nothing to be alarmed about.

So, the fundamental argument about lowering rates seems hard to hold. In any case it cannot justify a drop of more than 50 bps of the 10-year Treasury.

Low Treasury Issuance

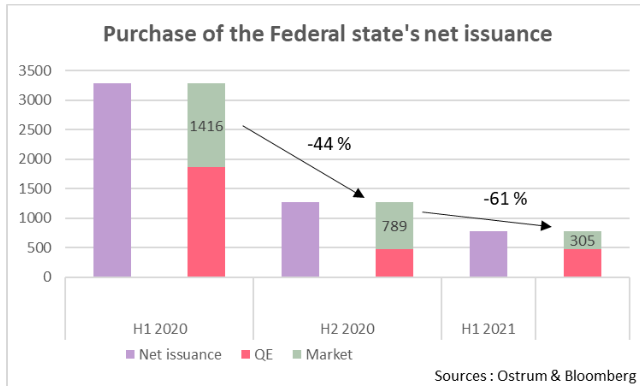
Paradoxically, despite an unprecedented deficit in the United States, the level of debt issuance is relatively low. The reason is the use of the CRF account. As a reminder, when the US Treasury has liquidity, it deposits it with the Fed, which therefore acts as a deposit account. This liquidity amounted to more than 1,600 billion dollars at the beginning of the year and the Secretary of the Treasury, Janet Yellen, decided to use it.

The result was a reduction of nearly 1,000 billion in this account, which enabled the deficit to be financed in lieu of debt issuance. The figures speak for themselves: the net debt issue was more than 3,000 billion in the first half of 2020, but only 780 billion in the first half of 2021, with a similar amount of deficit financing coming from the use of the Fed account, or 762 billion.

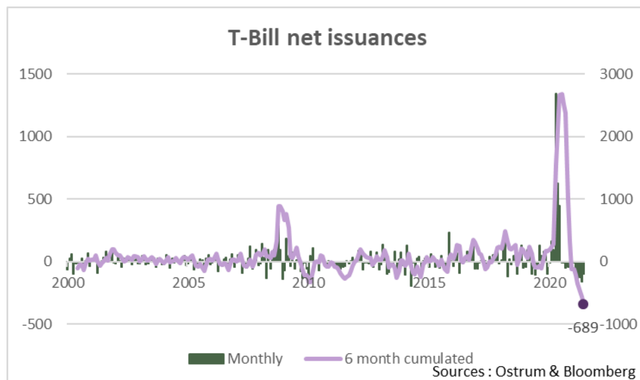


However, these figures still need to be reduced as the Fed's QE is also taken into account, which absorbs part of the net paper supply. Once this is taken into account, we have a drop in the issuances which is even more spectacular since the market had to absorb 1.4 Tr on the first half of last year but only 305 Bn on the first six months of 2021. Without going into too much detail, it is important to point out that the Fed's QE was higher than the net issues in April and May:

the volume of Treasuries available for the markets has therefore decreased over these two months. In the second quarter, the net issue, when QE is taken into account, was reduced to a small 167 billion.



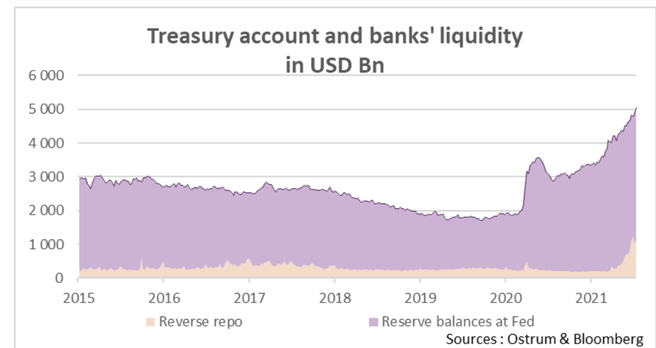
It may also be interesting to digress on the T-Bills, the short papers of the American treasury. The use of liquidity deposited with the Fed has particularly affected these instruments, which are used precisely for short-term liquidity management. T-Bill's stock of assets fell by 689 billion in the first half of the year, an unprecedented decline. To give an order of magnitude, the increase in the volume of T-Bills outstanding from 2010 to2019 has been 624 Bn: the US Treasury has thus removed in 6 month the equivalent of a decade of issuances! Again, prior to some of the Fed's actions it created market distortions with some of the shortest T-Bills dealing with a negative rate.



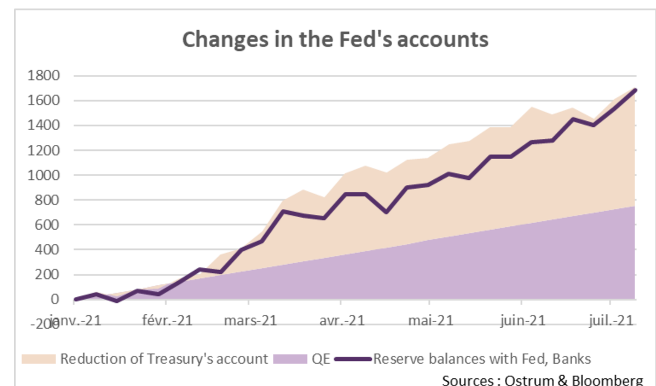
Liquidity Abundance

The counterpart of the use of the Treasury account is also to provide liquidity to the economy in general and to the financial system in particular. When the US Treasury uses the cash deposited with the Fed to finance its expenditures, it transfers its liquidity de facto to the banking system. Let's take a concrete example: an American citizen receives a cheque from the government, it is debited from the Treasury account to the Fed, but this cheque will be deposited in an American bank, which will therefore have an increase in its liquidity.

The chart below shows the evolution of surplus liquidity in the banking system. They increased by more than 2 Tr over the past year and by more than 1.7 Tr since the beginning of the year. Here too, to give an order of magnitude, the increase in liquidities between 2010 and 2020 was 2,2 Tr: what happened over the past year is thus more or less equivalent to a decade long move! This is a huge number and therefore a latent demand for assets, particularly Treasury.



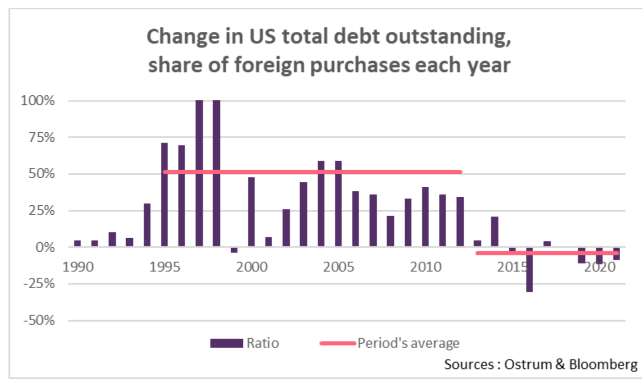
To be precise, the chart below shows the cumulative evolution of this bank liquidity since the beginning of the year. They are compared to the use of Treasury liquidity, which, as we said, is an equivalent liquidity endowment for the banks. QE should also be added: when the Fed implements its QE, it buys securities from the banking system and provides cash in exchange. So this is also a source of increased bank liquidity. The 1.7 Tr increase in liquidity of the banks corresponds quite precisely to the 950 Bn decrease in the Treasury account, added to the 750 Bn of QE.



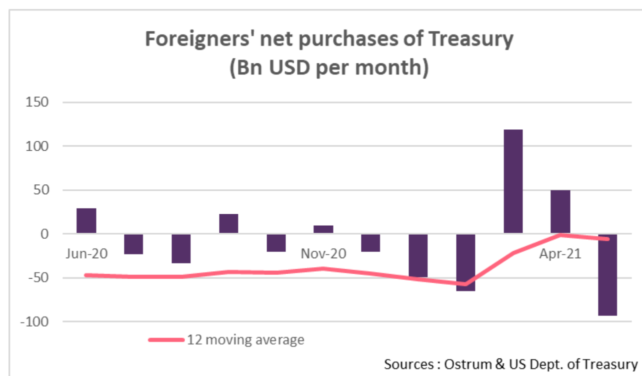
What about the foreigners?

The approach we have proposed until now is very focused on internal dynamics and liquidity balances in the U.S. market. A source of Treasury purchases is foreign investors.

However, their contribution must be put into perspective. From 1995 to 2012, foreign purchases represented on average half of the US government deficit. Since 2013, foreigners have been net sellers, averaging around 90 billion a year. Moreover, the most prolific year in purchases is only 165 billion (in 2014), a figure far from impressive.



However, international flows must not be completely forgotten. They can influence short-term changes as monthly volumes can be quite volatile. Over the current year, for example, purchases were 119 billion in March when US rates were at their highest. These same flows returned to negative in May when rates collapsed.



More generally, there is a significant correlation between the level of interest rates and the flows of foreign purchases. The current level of rates, needless to say, can be an incentive even if it should be pointed out that international flows aggregate official institutions and the private sector. Only the private sector is really sensitive to rates and more precisely to the premium hedged in the base currency.

Conclusion

The US debt issue declined considerably in the first part of this year as the US Treasury decided to use its liquidity to finance the deficit. When the Fed's QE share is taken into account, the net issuance in the first half of 2021 is 89% lower than in the first half of 2020. A considerable decrease therefore.

At the same time the inflow of liquidity into the banking system is absolutely unprecedented, 2 Tr over the past year, 1.7 Tr since January 2021. Treasury's request is obviously affected.

The US Treasury policy, along with the Fed's QE, has therefore created an extremely pronounced supply/demand imbalance. It seems to us that this explains a significant part of the decline in US rates. These arguments, however, are temporary, the Treasury account has returned to the desired level, or very close, and so emissions will resume. If our diagnosis is correct, the depressive effect on rates should fade, in which case rates would rise.

Foreigners do not provide market support at this rate. Here too, to generate demand, rates will have to increase.

Stéphane Déo

Market review

Citius, Altius, Fortius

The ECB reinforces its commitment to low rates, with the S&P 500 heading towards 4,400 points.

Questions about the impact of the epidemic rebound on global growth already seem to be fading as stock indexes post new highs. The buy-the-dip mantra indeed prevailed over virus fears. The earnings season is off to a good start and excess liquidity only adds to the current low interest rate environment. Christine Lagarde's communication also seems to foreshadow a prolonged period of low interest rates, which again encourages risk-taking. Market participants hence dialed down the probability of rate hikes by 2023. Despite some volatility on the risky asset markets, the risk-favored side prevailed towards the end of last week.

The ECB meeting would undoubtedly have been a non-event if it had not followed the strategic review unveiled earlier this month. The institution’s communication has evolved. The communiqué is intended to be clearer about the outlook for monetary policy and less jargonish. The inflation target is symmetrical around 2% with a "moderate" tolerance for faster price rises. The definition of price stability remains contingent upon the ECB's expectations. It thus differs from the Fed's Average Inflation Targeting framework, which implicitly takes into account periods of past low prices. In addition, Christine Lagarde presented the reaction function of the ECB as it relates to setting interest rates. If inflation turns out to be higher than expected, then the Governing Council should decide on the likely persistence of tensions over the medium term (about 3 years) and on the sustainability of the path of core inflation. These conditions make a rate hike unlikely over the next several years. The rate decision remains highly discretionary. The new reaction function drew criticism from Jens Weidmann and Pierre Wunsch, but there is a broad majority among Council members in favour of the new framework. The asset purchase strategy was not discussed. A communication on changes to QE programs is planned for next fall to take into account climate objectives and adjust the size of the programs once the pandemic emergency purchase program will be terminated. However, Christine Lagarde indicated that the PEPP could still be extended beyond March 2022.

Last week in the financials markets felt like the exact opposite of the previous one. The impressive rebound in equities seems to invalidate fears of a premature slowdown caused by the epidemic rebound. The European PMI surveys are reassuring on this point even if the indices of the most exposed countries will not be published until the beginning of August. The sharp decline in T-note yields remains an enigma. The acceleration to a weekly low at 1.126% has left its mark. The current yield level, still below 1.30%, seems inconsistent with current growth and inflation. The Fed, which is obviously insensitive to the level of rates, intervenes in markets in greater amounts than current Treasury bond net issuance. Repayment of T-bills has freed up cash that needs to be reinvested. US banks are recycling their excess cash into Treasuries despite less favorable regulatory treatment for government securities holdings since the end of March. In the euro zone, the ECB's speech was resolutely dovish. Short-term interest rate swaps priced out anticipated rate cuts for 2023-2024. The German Bund overshot to the downside implying increased downward pressure on term premiums. Bund yields thus fell below the -0.40% threshold. Germany will however remain very active on the primary in August. This could weigh on swap spreads. Recent rapid widening in swap spreads is somewhat unusual. The PEPP remains very impactful ahead of a likely seasonal reduction in purchases in August. Consensus long positioning in peripheral bonds could be a drag on performance going forward, but the reduction in Spain's financing needs (cut by € 20 billion for 2021) and the cancellation of Italian auctions in August ultimately leave few alternatives. Portugal may also adjust its issuance program downwards. Greek bond valuations (5-year bond yield in negative territory) all within the Italian curve reflect excesses even as an upgrade in the rating is likely in October (S&P BB pos). The ECB will also have to rule on the inclusion of Greece in the APP, when the PEPP expires. Italian BTP spreads narrowed by 2bp to 104bp at the weekly close.

Euro Investment grade credit spreads increased slightly (+1bp) although CDS indices finally seemed to follow in the footsteps of the equity market rally. The iTraxx IG index spread narrowed by 1bp to 46bp whilst the iTraxx Crossover gauge rallied by 6bp. In corporate bond markets, the yield on 1-3 year corporate bonds is flirting with all-time lows near -0.20%. Meanwhile, there are signs of spread decompression across parts of the high yield markets including subordinated and hybrid debt securities. US corporate credit, on the other hand, widened by around 5bp. High yield suffered the most from higher volatility in equities. It should be noted that, since June 15, lower-rated bonds have tended to underperform. Spreads on bonds rated B widened by 38bp compared with just 11bp on the BB. The primary market remains open, however, including for risky transactions. In this context, rising stars (from HY to IG) should be traded from the long side.

The equity market turned higher on opportunistic buying after the brief 3% correction. The earnings season is off to a solid start. Earnings comfortably beat consensus estimates 87% of the time on the S&P 500 and 70% of the time on the European Stoxx 600 gauge. All sectors fare well.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	26-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.73 %	-4	-8	-3
EUR Bunds 10y	-0.41%	-2	-25	+16
EUR Bunds 2s10s	32 bp	+2	-17	+19
USD Treasuries 2y	0.2 %	-2	-7	+8
USD Treasuries 10y	1.26 %	+7	-26	+35
USD Treasuries 2s10s	106 bp	+9	-20	+27
GBP Gilt 10y	0.58 %	+2	-20	+38
JPY JGB 10y	0.01 %	0	-4	-1
€ Sovereign Spreads (10y)	26-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	34 bp	-1	-1	+11
Italy	104 bp	-6	-4	-7
Spain	69 bp	+3	+5	+7
Inflation Break-evens (10y)	26-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	131 bp	+3	-3	-
USD TIPS	236 bp	+10	-1	+37
GBP Gilt Index-Linked	355 bp	+10	+5	+55
EUR Credit Indices	26-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	84 bp	+1	+1	-8
EUR Agencies OAS	43 bp	+1	+3	+2
EUR Securitized - Covered OAS	38 bp	+2	+7	+5
EUR Pan-European High Yield OAS	306 bp	+8	+9	-52
EUR/USD CDS Indices 5y	26-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	47 bp	-2	+0	-1
iTraxx Crossover	234 bp	-9	+4	-7
CDX IG	49 bp	-3	+1	-1
CDX High Yield	284 bp	-13	+10	-10
Emerging Markets	26-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	354 bp	+4	+18	+2
Currencies	26-Jul-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.178	-0.15	-1.2	-3.55
GBP/USD	$1.378	+0.77	-0.74	+0.8
USD/JPY	¥110.35	-0.81	+0.25	-6.43
Commodity Futures	26-Jul-21	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$74.2	$5.6	-$1.2	$23.0
Gold	$1 803.0	-$9.7	$24.5	-$95.4
Equity Market Indices	26-Jul-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	4 412	1.96	3.06	17.46
EuroStoxx 50	4 098	4.31	-0.55	15.35
CAC 40	6 567	4.31	-0.84	18.30
Nikkei 225	27 833	-1.58	-4.24	1.42
Shanghai Composite	3 467	-2.03	-3.88	-0.16
VIX - Implied Volatility Index	18.57	-17.47	18.89	-18.37

Source: Bloomberg, Ostrum Asset Management

Additional notes

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