Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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Hard compromise on European recovery fund

Key Points

- **European plan: grants likely to be cut**
- **Bund yields slightly up, peripheral bond spreads narrow**
- **Higher volatility in Shanghai and Nasdaq**
- **Credit and high yield tighten further**

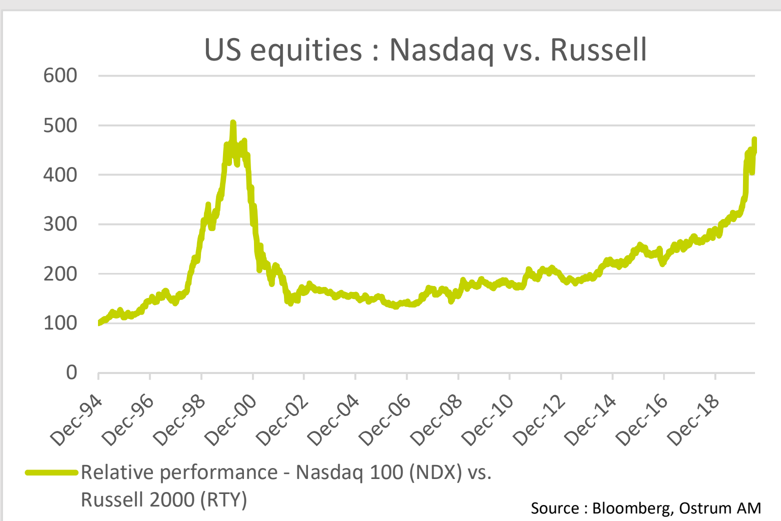
The seasonal decline in trading volumes was observed across the board. That said, risky asset markets remain well oriented last week although volatility picked up on Nasdaq early on in the wake of Shanghai's drawdown after an impressive rally since the beginning of July.

Negotiations on the European recovery fund should lead to a compromise deal acceptable for the so-called frugal countries. European summit weighed on Bund yields to a degree (-0.43%) whilst pushing sovereign spreads tighter. The euro keeps trading above $1.14. Credit continues to rally. Spreads narrowed by 8bp. European high yield richened further by 18bp last week.

T-note yields hover about 0.63%. US yield curve flattened. US spreads (credit, high yield) also narrowed. However MBS spreads moved wider reflecting refinancing activity risk after a plunge in long-term rates.

Emerging bonds remain well supported. EMBI spreads tightened further (-8bp) to 458bp at last week's close.

Chart of the week



The acceleration to the upside of Nasdaq echoes the late 1990s equity bubble. The tech-heavy Nasdaq 100 index is up 22% this year. Conversely the Russell 2000, which include more small-cap stocks is down about 12% in 2020.

The Nasdaq outperformance is being fueled by retail inflows, liquidity effect and accumulation of speculative longs in derivative markets. Valuations at 39x are now elevated which likely enhance the risk of price drawdown should earnings come in weaker than expected.

Hard compromise in Europe

Financial markets were well oriented ahead of the European summit that started last Friday. Over the past few weeks, German Chancellor Angela Merkel presses EU member states to agree on a recovery fund based on the EC proposal. Concerns of the frugal 4 including Austria, Denmark, Sweden and the Netherlands relate to duration and moral hazard associated with handouts to countries and regions that are most affected by the crisis. The size of the fund and multi-year EU budget could be reduced whilst rebates benefitting the Netherlands for instance could be prolonged. Negotiations had made little progress up to Sunday according to Italian officials. A cut in grants to €390b appears to be in the cards. The hoped-for Europe's Hamiltonian moment is hence postponed. The postponement of fiscal stimulus is no one's interest at this juncture. Besides short-term fixes aimed at avoiding bankruptcies resulting from liquidity shortages, this plan is an attempt to implement a new strategy for Europe taking into account solidarity needs, climate change risks and the transformation of EU economic model.

On the monetary front, the ECB will support any coordinated fiscal effort by EU member states. Issuance of joint EU debt is helpful to strengthen the international role of the euro at a time when dollar use may be questioned as the US raise pressure on China and the Hong Kong dollar peg to the US greenback. The governing council meeting was uneventful. The main takeout is that central bankers are reluctant to increase the reserve tiering multiplier shielding bank deposits from negative deposit rates (-0.50%). Actually, euro area banks may hold as much as 6 times their required reserves with the ECB at a 0% interest. ECB likely considers that the bonus rate on TLTRO-III (-1% in the first year) is playing this role now. Furthermore, downplaying Isabel Schnabel recent remarks on PEPP use, Christine Lagarde clearly indicated that the ECB plans to use PEPP purchases in full ($1.35T until June 2021) given downside risks on activity. In fact, fiscal policy dictates monetary creation and quantitative easing since 2015 is indeed irreversible.

In the US, the better data since May is sometimes overshadowed by the worrying evolution of the Covid pandemic. Retail sales confirmed their rebound in May (+7.5%m). Activity surveys (Empire, NFIB, PhilFed) were upbeat in July which points to sequential improvement in production. Inflation accelerated to 0.6%y in June. That said, consumer confidence and elevated initial jobless claims call for caution. Agreeing on another round of fiscal stimulus needed to avoid a plunge to household income is the most pressing issue at this point. The new fiscal package, which may boost federal deficit to 20pp of GDP, is a key input to the monetary policy outlook. The US Treasury department will announce its quarterly funding plan in early August. Supplemental borrowing needs justify maintaining Treasury purchases at the current pace. Sales of US Treasuries by non-resident accounts have sold from over 450b in the March-April period. The Fed will nevertheless have to rein in exponential growth of its balance sheet now above $7T. Fed yield targeting to stem asset holdings growth may thus still be on the agenda.

Rise in risky assets, despite wobbles in Shanghai markets

The European summit, lower primary activity since July start and an eventful ECB meeting have reduced trading volumes across financial markets. Bund yields are trading about -0.45% at close up 2bp on the week. Spread on sovereign bonds are broadly tighter as Italian BTPs break below the 160bp threshold against Bunds. ECB QE and recent issuance success in Italy (including the BTP Futura deal) have fostered a bullish consensus on Italy and other peripheral debt. Index-linked bonds perform better than nominal bonds. Breakeven inflation rates increased by 5bp in France last week. Expected inflation (52bp 10 years out) is underestimating upside risks to service prices in particular in the context of pandemic. In the US, yields on 10-year notes were down slightly last week to 0.63%. US rate volatility plunged enabling carry trades on longer-term bonds. Curve steepening trend is being reversed as 5s30s lost 8bp since the start of the month.

Equity markets have reacted to positive news on the vaccine front and US bank earnings buoyed by market activity. Loan loss provisions have nevertheless increased considerably hinting at a sharp deterioration in credit quality going forward. The S&P 500 still gained 2% last week hence erasing all 2020 losses. A rotation out of technology stocks was notable, including a sharp intraday correction last Monday. The plunge echoed a drop ion shanghai stocks (-5% last week) after a considerable run-up early on in July. In the euro area, cyclical stocks (autos, industry and transport) which are highly sensitive to the pandemic fallout do price in improving economic surveys of late.

As regards euro IG credit (138bp against Bunds), spreads have kept coming in thanks to lighter supply and continued credit fund inflows. In turn high yield continued to perform well.

Main Market Indicators

G4 Government Bonds	20-Jul-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.66 %	0	+1	-6
EUR Bunds 10y	-0.44%	-2	-3	-26
EUR Bunds 2s10s	22 bp	-2	-3	-20
USD Treasuries 2y	0.14 %	-1	-4	-143
USD Treasuries 10y	0.62 %	0	-8	-130
USD Treasuries 2s10s	48 bp	+1	-3	+13
GBP Gilt 10y	0.16 %	-2	-8	-66
JPY JGB 10y	0.03 %	-1	+1	+4
€ Sovereign Spreads (10y)	**20-Jul-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	30 bp	-2	-3	-1
Italy	155 bp	-10	-22	-5
Spain	83 bp	-3	-8	+17
Inflation Break-evens (10y)	**20-Jul-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	54 bp	+6	+5	-
USD TIPS	145 bp	+4	+16	-34
GBP Gilt Index-Linked	289 bp	-2	+3	-22
EUR Credit Indices	**20-Jul-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	135 bp	-8	-5	+42
EUR Agencies OAS	53 bp	-2	-1	+9
EUR Securitized - Covered OAS	41 bp	-2	-2	-1
EUR Pan-European High Yield OAS	507 bp	-18	+8	+203
EUR/USD CDS Indices 5y	**20-Jul-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	60 bp	-1	-7	+16
iTraxx Crossover	353 bp	-16	-37	+147
CDX IG	71 bp	-1	-5	+26
CDX High Yield	470 bp	-22	-26	+190
Emerging Markets	**20-Jul-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	458 bp	-8	-11	+168
Currencies	**20-Jul-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.146	+0.81	+1.77	+2.06
GBP/USD	$1.263	+0.13	+1.35	-4.76
USD/JPY	¥107.11	+0.06	-0.22	+1.37
Commodity Futures	**20-Jul-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$42.9	$0.1	$0.7	-$19.6
Gold	$1 813.0	$3.1	$58.0	$290.2
Equity Market Indices	**20-Jul-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 225	1.25	4.10	-0.19
EuroStoxx 50	3 369	0.57	3.06	-10.04
CAC 40	5 063	0.14	1.69	-15.30
Nikkei 225	22 717	-0.30	1.06	-3.97
Shanghai Composite	3 314	-3.75	11.68	8.66
VIX - Implied Volatility Index	26.22	-18.55	-25.34	90.28

Source: Bloomberg, Ostrum Asset Management

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