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The world in synchronous recession

Key Points

- **Equity markets take a breather, S&P bounced by 10% last week**
- **Questions on the $2T US fiscal package**
- **Fed action pushes yields lower, eases pressure on the US dollar**
- **Fed schemes to support credit and commercial paper markets**

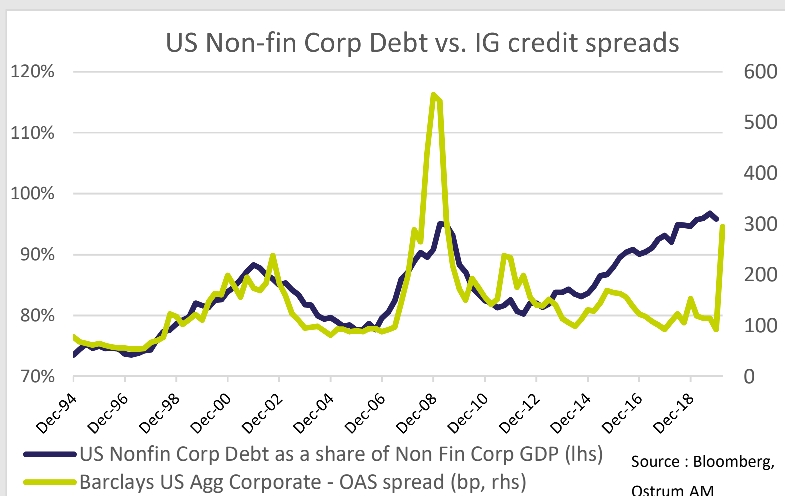
Despite still elevated volatility, equity markets bounced by as much as 10% last week in the US whilst Europe went up by 7%. Japan's Nikkei benchmark posted an outsized gain of 17%. Sector performances do not point to a sustained turnaround in stock markets. High implied volatility depicts an extreme level of risk.

Bond markets price in support from central banks, which are determined to discourage sellers. The yield on 10-year notes is trading below 0.70% as steepening pressure is slowly alleviating. Bund yields are drifting lower towards the ECB deposit rate of -0.50%. Yield volatility is diminishing somewhat.

Credit spreads have reacted favorably to Fed policy measures. Indeed, IG spreads have fallen back within 300bp in the US; In Europe, high yield benefitted from the upturn in stock prices but spreads stay close to 800bp. Emerging bonds exploded towards 650pb vs. US Treasuries.

Tensions on the US dollar are diminishing gradually amid concerted central bank interventions. The euro is trading above the $1.10 mark.

Chart of the week



The Covid-19 crisis reveals underlying financial fragilities. In the US, low rate policies have fostered increased indebtedness, which in turn fed stock buyback programs.

The level of spreads has long been inconsistent with the increased debt level shown here as a share of non-financial corporate GDP.

The current credit Krach is thus reconnecting market spreads with underlying fundamentals.

A 5% global contraction?

The health crisis is leading to a very deep global recession. Early revisions to GDP forecasts of the Economist Intelligence Unit (EIU) point to a contraction in global activity by more than 2%y. The gap to the initial growth trajectory is considerable (-5.1%y). China will slow sharply to 1%y growth in 2020. The sudden stop in Europe may shave 7% off this year's GDP in Italy and Germany. The French economy may contract by 5%y according to EIU forecasts. In the US, output loss will reach 2.9%y in 2020. Recovery scenarios vary enormously depending on the assumed effectiveness of sanitary measures and potential growth impact from corporate bankruptcies. Ruling out both a miraculous V-shaped recovery or darker scenarios in which economic and health policies fail, activity may only recoup its initial level in 2023 in both the US and Europe.

US $2T fiscal plan

The first signs of an economic collapse have emerged across a wide range of surveys. The service sector is bearing the brunt of the adjustment. Employment reacted almost immediately with 1.2 million people benefitted from partial unemployment schemes in France and fully 3.2mn initial jobless claims last week in the US. Contrary to "normal" recessions where aggregate demand shortfall impacts different sectors in a sequential manner, many sectors now face a sudden stop in activity. Unemployment benefits have been raised in the US to improve the effectiveness of the economic stabilizers, but job losses may lead to a loss of health insurance coverage for many individuals in the months to come.

Fiscal policy must always be temporary, timely and targeted to be a success. Handouts to households ($1.2k per person plus $500 per child) may be inadequate to foot healthcare bills. The $2T fiscal plan is indeed unprecedented but could be off target as it does not prioritize the healthcare crisis. Universal health coverage continues to face ideological resistance in the US. It is true that $150b will be traced to hospitals but it is hard to justify $50 bailout loans for airline companies. Fiscal choices also appear to reflect expectations of a swift return to normal business. The evolution of the epidemic in the US will quickly expose wrong-headed policies of the Trump Administration.

Respite in financial markets

Despite the recessionary backdrop, financial markets have rebounded. The S&P500 bounced by 10% last week as European indices gained some 7%. The sector performance breakdown is not reassuring though. The rebound in cyclicals (namely industrials, consumer discretionary) out oil sector outperformance, even as Brent oil prices dipped back below $26, are likely simply traceable to short covering.

Short-term market relief does not override the bear market backdrop. The market pickup is indeed traceable to Central Bank interventions. Swap lines between the Fed and other Central Banks have increased dollar supply to non-US banks by $200b so far. Upward pressure on the dollar has weakened, at least for the time being. A slightly weaker dollar does facilitate a return to risk assets. Tensions persist in commercial paper markets where outstanding debt amounts top $1.1T. The Fed launched an SPV designed to provide support the CP market. The ABCP market, the money market epicenter of 2008 crisis, suffered as yields climbed beyond 2%. Fed action also contributed to modest spread tightening beyond the very short maturities. The Federal Reserve announced two facilities to support corporate credit markets across both primary (PMCCF) and secondary (SMCCF) bond markets. The SPVs will be funded by Fed loans and US Treasury capital ($10b equity) and will purchase investment-grade corporate debt with maturities within 4 years in primary markets and residual maturities below 5 years in secondary markets. Corporate spread curves had flattened considerably as liquidity conditions worsened. Fed facilities may help to normalize spread curves. The average spread on US IG markets has already started to come down from a peak at 375bp to less than 300bp currently. Hence, despite the much-anticipated recession and the related deterioration in credit quality, the Fed is determined to keep credit flowing in the US economy. The reactivation of the Fed's TALF should ward off a sudden stop in securitization activity which is critical to student, auto or SME loan financing. The TALF scheme entails a safety net for structured credit markets (including CLOs) currently in free fall. Indeed, BB tranches trade at spreads in the ballpark of 1500bp. The pullback of Japanese investors sparked a sharp repricing in the AAA CLO tranches, which widen to as much as 500bp.

In European credit, liquidity conditions remain subpar, but investor interest is improving as evidenced by the reopening of primary corporate bond markets. Bond buyers have some market power at present amid ECB support, which will soon be deployed across markets, including commercial paper. Recent outflows from money market funds and the looming quarter-end closing will require decisive action from the ECB to assure adequate liquidity access to corporate borrowers. High yield markets remain volatile with enormous yield gaps nearing 800pb. In turn, the synthetic iTraxx crossover index is trading around 650pb.

Main Market Indicators

G4 Government Bonds	30-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.71 %	-2	+6	-11
EUR Bunds 10y	-0.54%	-16	+7	-35
EUR Bunds 2s10s	17 bp	-14	+1	-25
USD Treasuries 2y	0.24 %	-7	-68	-133
USD Treasuries 10y	0.62 %	-17	-53	-130
USD Treasuries 2s10s	38 bp	-9	+15	+3
GBP Gilt 10y	0.32 %	-11	-12	-50
JPY JGB 10y	0.02 %	-5	+17	+3
€ Sovereign Spreads (10y)	**30-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	44 bp	-5	+12	+14
Italy	199 bp	+4	+28	+39
Spain	109 bp	-5	+20	+43
Inflation Break-evens (10y)	**30-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	32 bp	+30	-34	-
USD TIPS	101 bp	+20	-42	-78
GBP Gilt Index-Linked	286 bp	+14	-14	-25
EUR Credit Indices	**30-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	241 bp	+5	+138	+148
EUR Agencies OAS	75 bp	+2	+28	+31
EUR Securitized - Covered OAS	63 bp	+8	+22	+21
EUR Pan-European High Yield OAS	802 bp	-87	+422	+498
EUR/USD CDS Indices 5y	**30-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	97 bp	-19	+30	+53
iTraxx Crossover	579 bp	-118	+272	+372
CDX IG	112 bp	-12	+45	+67
CDX High Yield	639 bp	-225	+267	+359
Emerging Markets	**30-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	624 bp	-49	+279	+334
Currencies	**30-Mar-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.103	+2.6	-1.33	-1.76
GBP/USD	$1.238	+7.12	-3.35	-6.66
USD/JPY	¥107.87	+3.11	-0.1	+0.66
Commodity Futures	**30-Mar-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$22.9	-$4.1	-$26.8	-$41.8
Gold	$1 622.5	$62.8	$24.1	$99.7
Equity Market Indices	**30-Mar-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	2 551	14.01	-13.65	-21.04
EuroStoxx 50	2 713	9.17	-18.50	-27.55
CAC 40	4 301	9.89	-18.99	-28.05
Nikkei 225	19 085	13.01	-9.73	-19.33
Shanghai Composite	2 747	3.27	-4.62	-9.93
VIX - Implied Volatility Index	64.25	4.32	60.18	366.26

Source: Bloomberg, Ostrum Asset Management

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