STRATEGY WEEKLY

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The unthinkable oil crash

Key Points

- **Crude oil traded at negative prices**
- **Is there an expectation bubble in equities?**
- **Record US IG corporate bond issuance**
- **S&P maintains Italy's sovereign rating**

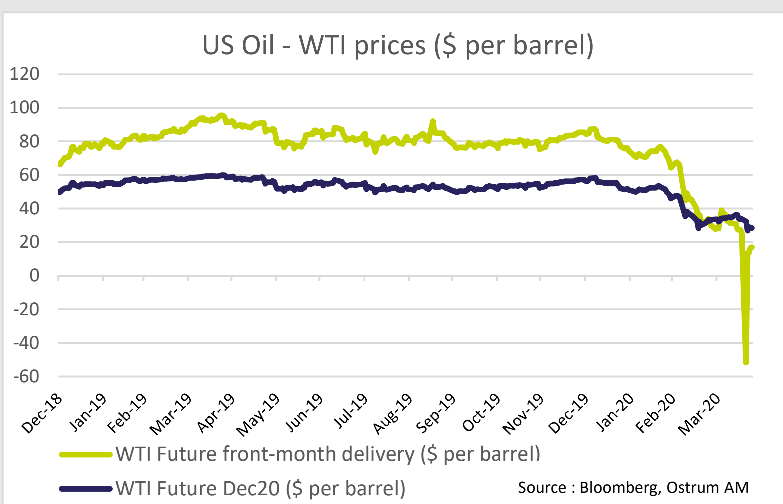
The oil crash resulted in an unheard-of situation of negative crude prices. In this context, equity markets lost some ground last week with performances ranging from -1.4% (S&P500) to about -3% (Euro Stoxx 50, Nikkei 225). European banks continue to plummet as total returns now approach -50% in 2020.

The T-note yield hovers about 0.60%. US credit supported by FED facilities resisting a deluge of issuance since the beginning of March. IG spreads trade about 210bp vs. Treasuries.

In Europe, Bunds hit -0.50% and, while volatility remains in peripheral bond markets, ECB buying ensures that sovereign issuers retain market access. Italy was not downgraded by S&P (BBB), which is a stabilizing element. Credit remains well oriented given attractive spread levels near 200bp vs. Bunds.

The US dollar remains strong and actually only the Japanese yen manages to resist excess demand for the greenback. The euro is trading about $1.08. Meanwhile Latin-American currencies are under pressure.

Chart of the week



Oil prices collapsed ahead of the future contract roll date onto the June expiry.

Plummeting crude prices resulted in an unprecedented situation of negative prices. At the low point on April 20th, the May delivery price hit a low at $-55.

Excess supply will not be corrected by the OPEC+ deal. Indeed, storage capacity, including tankers, is close to saturation levels. December 2020 prices also plunged below $30, which is insufficient for most global producers to turn a profit.

Crude crashing

Last week's event is unquestionably the collapse in oil prices. The May delivery contract traded down to *negative* prices, which is a hard concept to come by. The WTI barrel hence changed hands for $-55 at the lowest point on April 20. Producers are hence forced to pay consumers. In fact, some oil-producing companies triggered 'force majeure' clause (or 'Act of God') to avoid making payments to customers. The sharp price drawdown can be explained by economic equilibrium in physical oil markets and features of the futures markets where ETFs hold outsized long positions. The collapse in oil demand is estimated anywhere between 25 to 25mbpd over the next two months. However, the OPEC+ deal with some other producers will cut output by no more than 15mbpd. Storage capacity are almost fully used and floating storage appears no longer profitable after freight prices jumped. The US government may subsidize producers to cut production and add to strategic reserves though current US storage capacity limits potential buying to 70mbpd. Bankruptcies of shale oil producers will contribute to resorb excess supply over time but it is quite obvious that OPEP+ will have to reconvene very shortly to adjust its strategy.

Equities in an expectation bubble

On economic grounds; surveys depict a sudden stop in activity across all sectors of the economy in both Europe and the US. Optimism nevertheless transpires in the April ZEW survey but this may be more a reflection of the recent bounce in equity markets than underlying signs of economic recovery. Indeed, the German IFO index points to significant weakness over the months to come. One can fear that the rebound in equity markets represents a dangerous expectation bubble.

Equities writing off 2020

European equities have stabilized around 2800 on Euro Stoxx 50, about 1000 points below February highs. A sharp 25-30% drop in earnings is now projected for 2020 for European indices but analysts forecast a swift recovery 2019 profit levels next year. In the US, 2021 earnings forecasts stand even 15% above last year's level.

It is not unusual to see equities looking through the earnings trough, but the current unprecedented crisis argues for a risk premium and a sustained discount in valuation multiples. Volatility indeed remains elevated. The V2X index is trading about 40% compared with 14% in mid-February. Most companies refuse to provide earnings guidance and dividend payments will be cut by up to 40%.

Corporate earnings in the small cap universe have also been adjusted to the downside. The European banking sector continue its free fall with a -50% total return since the start if the year. Banking stocks have not rebounded at all even as contingent capital securities (Tier 1) managed to participate to risky asset rally since late March.

Pickup in credit inflows

In fixed income markets, the Treasury bond market looks very quiet. Yield volatility has vanished under Fed buying so that 10-year notes hover about 0.60%. The decline in daily Fed purchases could pave way for a policy of long-term yield targeting. The yield curve is currently steep and lower volatility will foster the implementation of flatteners. Higher spread volatility persists in MBS markets given likely difficulties in housing over the coming months (housing price falls, defaults, liquidity risk).

In US credit markets, primary market issuance hit record levels in the past month. Fed monetary support sparked the recovery in issuance but the induced rise in leverage combined with the expected decline in EBITDA may result in higher gross leverage and hence rating downgrades. The average IG spread is close to 210bp vs. US Treasuries. High yield continues to be supported by Fed purchases which now include fallen angels and high yield ETFs. Flows into investment grade and high yield funds have improved considerably.

In the euro area, Bund yields hit their practical floor, which may be the ECB deposit rate at -0.50%. Sovereign issuers have maintained market access thanks to the ECB's PEPP (€70b spent so far out of €750b planned). Peripheral spreads tend to move wider ahead of sovereign bond issuance. Primary market issuance premiums are significant (for instance 17bp premium on the last BTP 2050 deal). The unchanged S&P rating (BBB negative outlook) will provide some relief in the near term before Moody's updates its rating on May 8 (Baa3 stable). The ECB will meet on Thursday. The Central Bank stands ready to do more and expand the PEPP further. In fact, the difficult to craft a common fiscal response to the coronavirus crisis forces the ECB to do ever more and assume more risks. The ECB will continue to accept collateral which were IG-rated on April 7 and downgraded to high yield (down to BB-) thereafter. Pan-European high yield offers spreads of around 672bp at present.

Lastly, the US dollar remains in high demand ($1.08). A break below $1.07 may spur the reinstallation of speculative short positions. The yen looks to be a better bet.

Main Market Indicators

G4 Government Bonds	27-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.67 %	0	+1	-7
EUR Bunds 10y	-0.46%	-1	+2	-27
EUR Bunds 2s10s	22 bp	-1	+1	-20
USD Treasuries 2y	0.23 %	+3	-1	-134
USD Treasuries 10y	0.62 %	+2	-5	-129
USD Treasuries 2s10s	39 bp	-1	-4	+4
GBP Gilt 10y	0.29 %	-4	-7	-53
JPY JGB 10y	-0.04 %	-6	-5	-2
€ Sovereign Spreads (10y)	27-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	48 bp	-4	+6	+18
Italy	221 bp	-18	+41	+61
Spain	136 bp	+3	+35	+71
Inflation Break-evens (10y)	27-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	30 bp	-2	+1	-
USD TIPS	113 bp	+18	+12	-65
GBP Gilt Index-Linked	272 bp	-1	-15	-39
EUR Credit Indices	27-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	194 bp	-6	-53	+101
EUR Agencies OAS	75 bp	+0	+0	+31
EUR Securitized - Covered OAS	69 bp	+1	+13	+28
EUR Pan-European High Yield OAS	672 bp	+8	-225	+368
EUR/USD CDS Indices 5y	27-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	82 bp	-3	-11	+38
iTraxx Crossover	495 bp	-10	-75	+289
CDX IG	93 bp	+4	-12	+48
CDX High Yield	663 bp	+49	+63	+383
Emerging Markets	27-Apr-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	638 bp	+32	-52	+348
Currencies	27-Apr-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.085	-0.2	-2.63	-3.39
GBP/USD	$1.243	-0.32	-0.28	-6.32
USD/JPY	¥107.04	+0.59	+0.84	+1.44
Commodity Futures	27-Apr-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$19.6	-$6.0	-$8.3	-$44.5
Gold	$1 717.1	$22.5	$88.9	$194.3
Equity Market Indices	27-Apr-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	2 858	1.22	12.44	-11.55
EuroStoxx 50	2 858	-1.77	4.74	-23.69
CAC 40	4 456	-1.59	2.41	-25.45
Nikkei 225	19 783	0.58	2.03	-16.37
Shanghai Composite	2 815	-1.30	1.56	-7.69
VIX - Implied Volatility Index	35.20	-19.69	-46.29	155.44

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