MyStratWeekly

Market views and strategy

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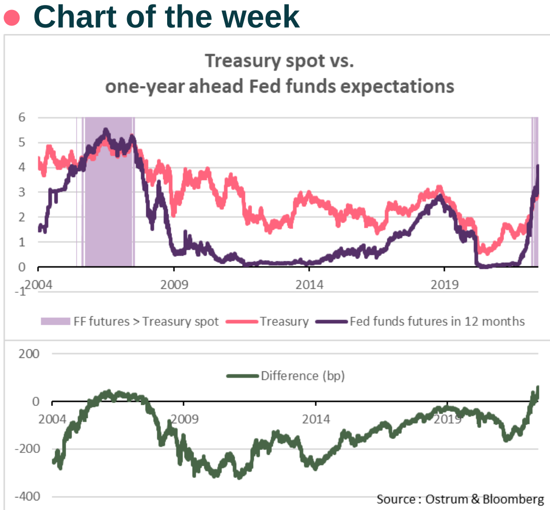
Topic of the week: Market; between paradox and inconsistency

- **With the extremely rapid change in central bank attitudes, and now that support for extremely accommodative monetary policies is dissipating, markets are in the middle of a "price discovery" process;**
- **Markets are expecting a fast-paced monetary tightening, but risk premiums, if normalized, remain close to their long-term average;**
- **The market does not agree with itself: either the expected monetary tightening materializes and the risk premiums are too low. Either risk premiums are right not to panic, but then the monetary tightening will be less aggressive.**

Market review: The problems posed by inflation remain intact

- **Equity plunge as Fed fails to reassure markets;**
- **Unheard-of volatility in fixed income markets;**
- **ECB calls emergency meeting, aims at containing spreads;**
- **SNB raises rates for first time in 15 years.**

Chart of the week



One-year Fed fund expectations are at 3.80% while the 10-year rate is at 3.23%. Fed funds are therefore expected to go well above long rates. If we measure the slope of the curve by the difference of these two figures, it is the strongest inversion ever recorded.

In terms of monetary policy, this means that expectations of monetary upturn by the market are well beyond a return to a neutral rate. This is a move towards a very restrictive monetary policy.

Figure of the week

150

Source : Ostrum AM

The level in basis point mentioned by Ignazio Visco last week on the Italian spread "acceptable" in terms of fundamentals by the Bank of Italy.

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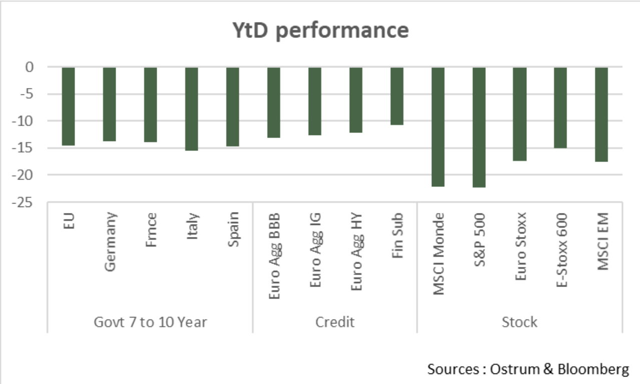
Topic of the week

Market; between paradox and inconsistency

With the extremely rapid change of attitude of central banks, and now that the support of enormously accommodative monetary policies is dissipating, markets are in the middle of a “price discovery” process. In this article we analyze the distortion of risk premiums since the beginning of the year, one of the fundamental elements of this “price discovery” process. With, as often when prices move so fast, some paradoxes inevitably appearing, but also what seems to us to be clear inconsistencies.

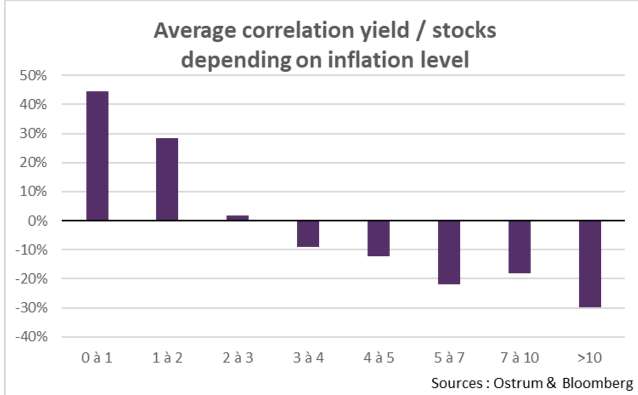
All together

Market volatility has increased tremendously in recent weeks. Risky assets have suffered greatly and all asset classes have shown a uniformly negative performance since the beginning of the year. The chart below shows that since the beginning of the year, rates, equities and credit have consistently lost 10-15% of their value.



This is an unusual situation. Since the beginning of the century, every stock market correction of more than 15% has been accompanied by a fall in yields, and thus a positive performance of a bond portfolio that consequently played its role as a hedge. This is not the case this year and diversification by asset classes has therefore not produced the expected results.

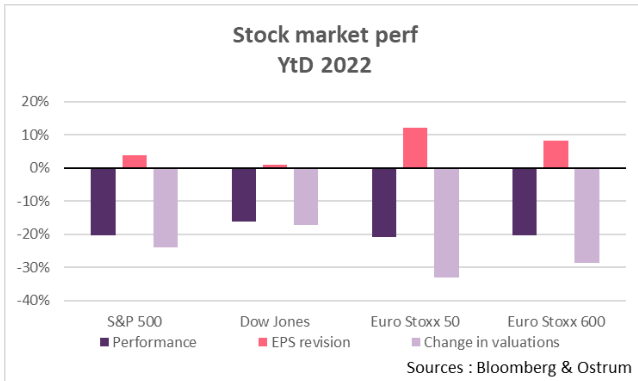
If this situation is very unusual in view of the last two decades, it is not so unusual if one takes into account the economic context, and therefore the reasons for this correction. The chart below uses the performance of U.S. yields and equities, on a time frame spanning almost 45 years. Over this period, history shows that the movements of rates and stocks tend to be in the same direction when inflation is low. This is logical: in case of low inflation, and therefore a stable one, it is growth-related movements that dominate and therefore good news on this front makes both rates and equities rise (or lower both in case of bad news). A bond portfolio, in this context, therefore tends to move in the opposite direction of an equity portfolio, and plays its role of diversification well.
When inflation is high, however, the relationship is reversed. This is the current situation where rates are rising too fast, driven by inflation, which in turn is negative for equities: the equity and bond portfolios are falling in parallel.



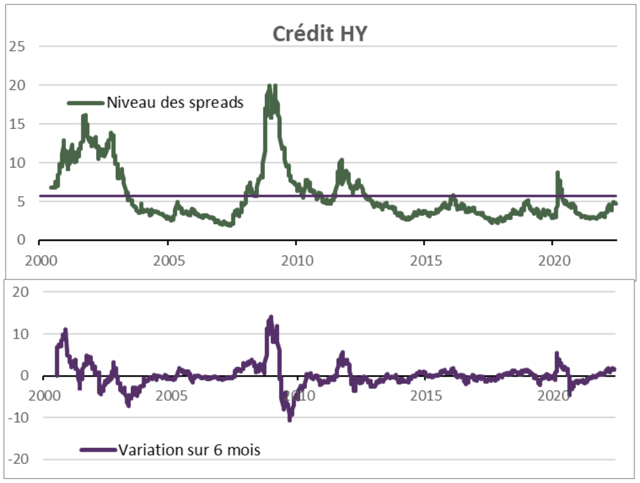
If this explanation is the correct one, the situation will continue and the ability to diversify an equity investment via a bond portfolio has disappeared.

An extremely violent move in risk premiums

This general underperformance must be attributed mainly to the rise in rates and risk premiums. The graph below breaks down the performance of the stock markets according to the variation in expectations on the BpA and the variation in valuations. It is very clear that the correction is not related to fundamentals (the expectations of BpA have been revised upwards) but to valuations.



To take an example from another asset class, credit, the chart below illustrates the speed of adjustment. The change in IG credit spreads over the last six months is around 75 bps. To find a more rapid marked adjustment, we need to go back to three episodes: 2009 after Lehman, 2011 and the sovereign crisis or 2020 and the Covid period. The pace of the adjustment is thus fully akin to a crisis level.



To expand the asset spectrum, we need to introduce the «BouPers», developed with the help of our excellent quants! The idea is to look at the reaction of a series of asset classes and compare it with their usual behavior.

We identify over- or under-reactions with the idea that these extreme movements will finally be corrected in the future. In the table below the red dots show the asset classes that underperformed their usual reaction to a Bund variation.

The message is clear: the vast majority of asset classes in the interest rate space (sovereign or credit) performed significantly worse than usual. We are therefore in a situation where spreads have over-reacted to the rise in the Bund and thus generated an unusually negative performance. Again, this should be interpreted as a sign that risk premiums on this various asset classes have adjusted very quickly.

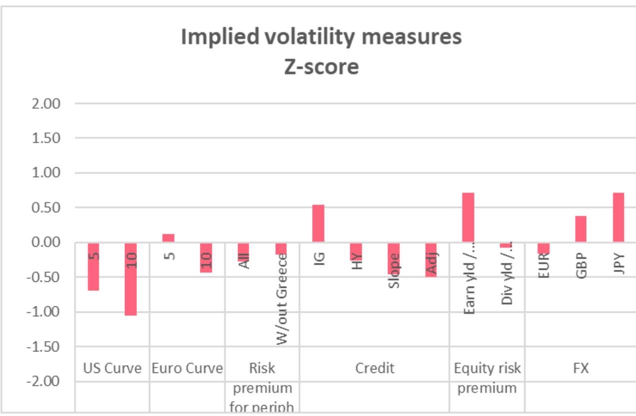
			Ref. Index = BCEG9T	Sur/sous performance depuis un mois
Taux			**Indice**	**Vol adj.**
Govvies	**Allemagne**	**1 à 3**	Bloomberg Germany Govt 1 to 3 Year TR	**-0.43**
		5 à 7	Bloomberg Germany Govt 5 to 7 Year TR	**-0.07**
			Bloomberg Germany Govt 7 to 10 Year TR	
		>10	Bloomberg Germany Govt Over 10 Year TR	**-0.01**
	France	**1 à 3**	Bloomberg France Govt 1 to 3 Year TR	**-0.67**
		5 à 7	Bloomberg France Govt 5 to 7 Year TR	**-0.33**
		7 à 10	Bloomberg France Govt 7 to 10 Year TR	**-0.27**
		>10	Bloomberg France Govt Over 10 Year TR	**-0.24**
	Italie	**1 à 3**	Bloomberg Italy Govt 1 to 3 Year TR	**-0.85**
		5 à 7	Bloomberg Italy Govt 5 to 7 Year TR	**-0.71**
		7 à 10	Bloomberg Italy Govt 7 to 10 Year TR	**-0.67**
		>10	Bloomberg Italy Govt Over 10 Year TR	**-0.62**
	Espagne	**1 à 3**	Bloomberg Spain Govt 1 to 3 Year TR	**-1.07**
		5 à 7	Bloomberg Spain Govt 5 to 7 Year TR	**-0.79**
		7 à 10	Bloomberg Spain Govt 7 to 10 Year TR	**-0.72**
		>10	Bloomberg Spain Govt Over 10 Year TR	**-0.63**
	Portugal	**1 à 3**	Bloomberg Portugal Govt 1 to 3 Year TR	**-1.78**
		5 à 7	Bloomberg Portugal Govt 5 to 7 Year TR	**-0.94**
		7 à 10	Bloomberg Portugal Govt 7 to 10 Year TR	**-0.78**
		>10	Bloomberg Portugal Govt Over 10 Year TR	**-0.67**
Agency	**Agency**		Bloomberg EuroAgg Agency Total Return Index Value Unhedged EUR	**-0.43**
Agency	**Agency**		Bloomberg Euro-Agg Agencies Total Return Index Value Unhedged EUR	**-0.44**
Corporate	**Maturité**	**1 à 3**	Bloomberg EuroAgg Corporate 1-3 Year TR Index Value Unhedged	**-0.75**
		3 à 5	Bloomberg EuroAgg Corporate 3-5 Year TR Index Value Unhedged	**-0.61**
		5 à 7	Bloomberg EuroAgg Corporate 5-7 Year TR Index Value Unhedged	**-0.52**
		7 à 10	Bloomberg EuroAgg Corporate 7-10 Year TR Index Value Unhedge	**-0.47**
	Note	**Aaa**	Bloomberg EuroAgg Corporate Aaa Total Return Index Value Unhedged EUR	**-0.38**
		Aa	Bloomberg Euro-Aggregate: Corporate -- Aa TR Index Unhedged EUR	**-0.40**
		A	Bloomberg EuroAgg Corporate A Total Return Index Value Unhedged EUR	**-0.48**
		Baa	Bloomberg EuroAgg Corporate Baa TR Index Value Unhedged EUR	**-0.63**
	Secteur	**Utilities**	Bloomberg EuroAgg Utilities Total Return Index Value Unhedged EUR	**-0.57**
		Indust	Bloomberg EuroAgg Industrials Total Return Index Value Unhedged EUR	**-0.45**
		Sub	Bloomberg Euro Corporate Insurance Subordinate Total Return Index Value	**-0.82**
		Senior	Bloomberg Euro Corporate Insurance Senior Total Return Index Value Unhe	**-0.41**
		Tier 1	Bloomberg Banking Tier 1 Total Return Index Value Unhedged EUR	
		Upper Tier 2	Bloomberg Banking Upper Tier 2 Total Return Index Value Unhedged EUR	
		Lower Tier 2	Bloomberg Banking Lower Tier 2 Total Return Index Value Unhedged EUR	**-0.54**
		Senior	Bloomberg Euro Banking Senior TR Index Value Unhedged EUR	**-0.49**
		Fin SNR (IG)	ICE BofA Euro Unsubordinated Financial Index	
		Fin SUB (IG)	ICE BofA Euro Subordinated Financial In	
		Corp SNR (IG)	ICE BofA Euro Senior Non-Financial Index	
		Corp HYB (IG)	ICE BofA Euro Non-Financial Subordinated Index	

Source : Ostrum

But not (yet!) over-adjustment

To come back to the case of credit, it should be noted, however, that the level of spread reached is ultimately not that far from the long-term average. Paradoxically, therefore, and despite the surge in volatility, risk premiums are not excessive in the majority of cases but on the contrary they are close to their long-term average.

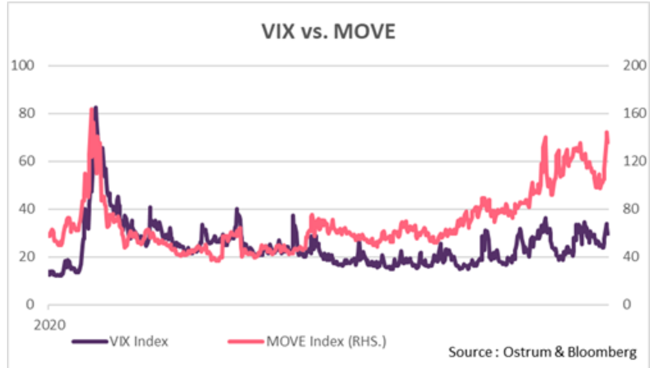
The following chart shows our risk premium calculations for a wide range of asset classes. We have standardized these risk premiums to make them comparable, and show the z-score (divergence to the long-term average). First, we note that the term premiums on the US and European curve are still slightly below their long-term average. Our estimates of the risk premium on peripherals or on credit are very close to their long-term average. For equities the premium is slightly higher.



This therefore validates the idea that the movement we have witnessed is more a return to the long term average of risk premiums that had been artificially compressed during the QE period.

However, a caveat to this general approach is that there are, of course, more pronounced pockets of stress. Another market inconsistency is the divergence of views on implied volatility between equity and fixed income markets. At the time of writing, the VIX is below 30%, a high level indeed, but still very reasonable. In contrast, MOVE, the equivalent of VIX for Treasury markets, is at 134%, a much more unusual and high level.

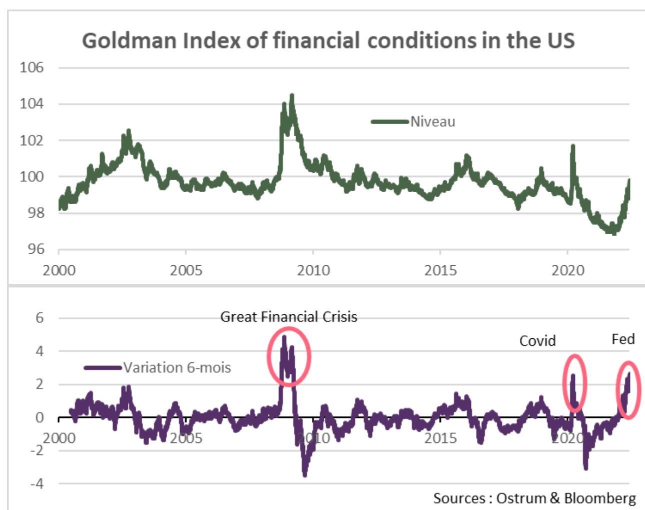
So there is an unusual divergence here too, between the two markets with a stress on rates that has not, paradoxically, completely contaminated the equities part.



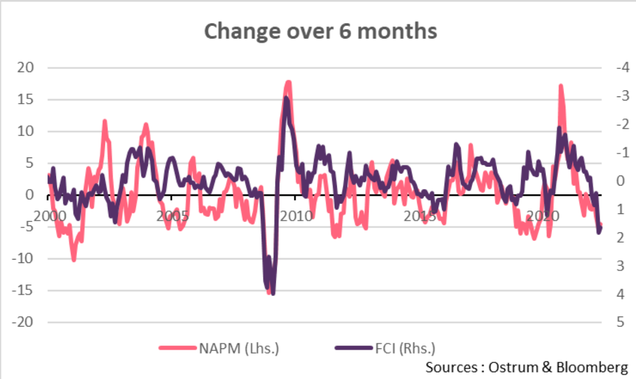
Growth?

One of the consequences of this movement is the impact on the economy, which leads us to a new market inconsistency. Below is the Goldman Financial Conditions Index. It takes into account a set of financial variables: rates, credit, shares, etc. Here again the current level is not aberrant, it is close to the long-term average, which validates once again the idea that risk premiums have not for the moment over-adjusted, but rather converged towards a level compatible with their long-term average.

Much more concerning is the variation of this index over 6 months. This is the worst variation since the great post-Lehman financial crisis and it is worse than the panic caused by the pandemic in early 2020. The result is therefore a very large marked tightening of financial conditions.



If we go one step further, it should be noted that the change in these financial conditions is a leading indicator, certainly imperfect, of the US PMI from ISM report on business. A simple econometric approach suggests that the tightening we have just seen would lead the PMIs to under 50 by the end of the year. We should therefore expect a recession in the United States. Of course, we should not literally read these models, which are inherently imprecise, but it is nevertheless clear that what is happening in the markets today can only lead to a slowdown in activity before the end of the year.



If this is the case, risk premiums have probably not yet adjusted sufficiently, at least they are not compatible with a recession.

Conclusion

When markets move as fast as they have since the beginning of the year, they inevitably generate paradoxes or inconsistencies. With the sudden withdrawal of the central banks, the compression of risk premiums disappears, and the easing of the rubber band gives rise to an accelerated repricing. Probably the most glaring inconsistency is the implied divergence of volatility between the (extreme) yield market and the (reasonable) equities. An unusual divergence not bound to last.

More fundamentally, the markets expect monetary tightening at high speed by the two main central banks, the Fed and the ECB, but also very rapid movements in most countries of the world which have all of them the same major inflation problem. Such a monetary tightening can only have a negative impact of magnitude on the activity (this is moreover the aim), but in this case, the normalization of risk premiums is insufficient. A return to normal is compatible with a “normal” environment, not a crisis.

The market does not agree with itself: either the expected monetary tightening materialize and it is difficult to see how risk premiums could remain gently at their long-term average. Or risk premiums are right not to panic, but then the monetary tightening will be, in all likelihood, less aggressive than what is priced.

A fundamental inconsistency that still promises us a lot of movement in the markets.

Stéphane Déo & Thierry Blais

Market review

The problems posed by inflation remain intact

Markets plunge, the ECB calls an emergency meeting whilst the Fed fails to fully apprehend inflation risks

Global fixed income markets are experiencing unprecedented volatility. The amplitude of daily variations on US 10-year bonds exceeded the 15 bp threshold for five consecutive sessions. Last Thursday, the day after the FOMC, the T-note traded at 3.48% yields before plunging to 3.19% at the close as stock markets collapsed. Far from having reassured market participants, the Fed still seems to be lagging behind market expectations. A sense of panic set in, so the ECB called an emergency meeting just a week after the June Governing Council. The post-meeting statement did not bring any new information, but Bank of Italy Governor Ignazio Visco attempted to stabilize markets by mentioning an equilibrium level of 150 bps on the Italian 10-year spread. Negotiations within the Council are likely heated as the ECB tries to spare the most fragile markets and proceed with the monetary tightening required to mitigate inflation pressures. Liquidity has disappeared from credit markets and fund outflows receded. Elsewhere, the SNB surprisingly raised its key rate by 50 bp for the first time in 15 years. Conversely, the BoJ chose to resist market pressure and thus must keep increasing its daily bond purchases. The BoJ's action only shifted the selling pressure from the bond markets towards the Japanese currency.

The chaos on the markets is commensurate with the inflationary risk. The announcement of the ban on insuring Russian cargo ships raises fears of an explosion in oil prices this summer. US strategic reserves are dwindling faster than expected. Russia reacts by cutting off gas to Germany, jeopardizing the replenishment of stocks before winter.

The Fed's decision to raise rates by 75 bps failed to bring stability to markets. The Fed is constantly trailing market expectations. In fact, the level of 1.75% on Fed funds remains below the supposed neutrality rate (2.5% according to the DOT plot) while inflation is 8.6% and unemployment stands at 3.6%. Neutrality should be reformulated into a real rate of 0.5%. In addition, the size of the current balance sheet does raise the neutral level on Fed rates. The hoped-for reality check from Fed policymakers remains elusive considering the projection for 2% inflation in 2024. The debate on the need for a recession to bring inflation down is not yet open. If the financial markets are in doubt regarding the inflation outlook, households do not foresee a decline in inflation. All the surveys point to a upward shift in household inflation fears.

The ECB is no exception. The emergency meeting, held a few hours before the FOMC, resulted in a dry statement requiring subsequent verbal interventions from Christine Lagarde and Ignazio Visco to prevent full-fledged panic over Italian debt. The rate hikes planned for this summer, the magnitude of which remains to be determined, will serve as a bargaining chip for the implementation of an anti-fragmentation tool, which sounds like yet another iteration of the bailout of Italy. The balancing act will consist of managing spreads to compensate for the rise in rates while maintaining the balance sheet size unchanged. PEPP flows will be reallocated. Reference to the transmission of monetary policy also evokes banking risks. Italian banks are indeed dependent on the ECB for €450 billion.

Market price action is daunting. The Bund soared to approach 2% while the Italian spread was close to 240 bp. Positions in peripheral spreads had nevertheless diminished, but the selling pressure reappeared until the verbal intervention of the central bankers. BTPs then tightened to 190 bp. Institutional accounts nevertheless benefited from the price weakness in OATs or Bonos in particular, thus mitigating the rise in long yields. At the same time, the T-note flirted with 3.5% before falling back to 3.2% on Friday. The yield curve is essentially flat. The bearish consensus in the hedge fund community is expressed on short-term contracts. The money market is pricing in a reversal in 2024. The rise in the earnings discount factor continues to weigh on the fair value of equities. The sensitivity of the Nasdaq to the long rate is well documented, so that the technology index plunged by almost 10% last week. The fall in stock prices is homogeneous in the United States except for the larger drop in oil stocks under pressure from the Administration to lower prices. The threat of a windfall tax is making its way through the Democratic ranks. The midterm elections are indeed on everyone's mind.

The credit market recorded another week of intense fund outflows, in both investment grade and high yield. Spreads have widened by 30 bp and 63 bp respectively since the beginning of the month. The movements are similar in the United States with a greater underperformance of high yield. The lack of liquidity increases as the market adjusts to a new reality without the support of the ECB. The CSPP flows to be redeployed amount to 23 billion over the next 12 months. Issuance premiums reappear as credit demand wanes.

The foreign exchange market is just as lively. The euro is hovering around $1.05, with the commitment to contain spreads somewhat reassuring to market participants. The dollar remains the barometer of risk aversion. The yen resumed its downward path, the BoJ's inertia implying a frenzied easing of yen liquidity. The Japanese currency should retest the recent lows, which means above 135 on the USD-JPY parity.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	20-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	1.09%	-6	+75	+171
EUR Bunds 10y	1.67%	+4	+72	+185
EUR Bunds 2s10s	56.9bp	+9	-3	+13
USD Treasuries 2y	3.18%	-18	+60	+245
USD Treasuries 10y	3.23%	-13	+44	+172
USD Treasuries 2s10s	3.9bp	+4	-16	-74
GBP Gilt 10y	2.51%	-2	+62	+154
JPY JGB 10y	0.24%	-2	+1	+5
€ Sovereign Spreads (10y)	20-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
France	57.28bp	-5	+6	+20
Italy	196.96bp	-42	-3	+62
Spain	110.28bp	-26	+0	+36
Inflation Break-evens (10y)	20-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2.48%	-21	-33	+38
USD 10y Inflation Swap	2.89%	-20	-11	+12
GBP 10y Inflation Swap	4.08%	-12	-39	-10
EUR Credit Indices	20-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	197bp	+27	+34	+102
EUR Agencies OAS	73bp	+4	+10	+24
EUR Securitized - Covered OAS	79bp	+6	+8	+33
EUR Pan-European High Yield OAS	552bp	+68	+68	+234
EUR/USD CDS Indices 5y	20-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
iTraxx IG	111bp	+7	+11	+63
iTraxx Crossover	554bp	+34	+68	+311
CDX IG	100bp	+3	+7	+51
CDX High Yield	577bp	+10	+46	+284
Emerging Markets	20-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	500bp	+33	+33	+132
Currencies	20-Jun-22	1wk (%)	1m (%)	2022 (%)
EUR/USD	$1.052	1.066	-0.417	-7.5
GBP/USD	$1.224	0.832	-1.963	-9.6
USD/JPY	JPY 135	-0.193	-5.049	-14.6
Commodity Futures	20-Jun-22	-1wk ($)	-1m ($)	2022 (%)
Crude Brent	$113.4	-$8.9	$3.4	50.56
Gold	$1 840.9	$21.6	-$5.6	0.64
Equity Market Indices	20-Jun-22	-1wk (%)	-1m (%)	2022 (%)
S&P 500	3 675	-5.79	-5.81	-22.9
EuroStoxx 50	3 445	-1.65	-5.81	-19.9
CAC 40	5 881	-2.34	-6.43	-17.8
Nikkei 225	25 771	-4.51	-3.62	-10.5
Shanghai Composite	3 315	1.84	5.37	-8.9
VIX - Implied Volatility Index	31.92	-6.17	8.46	85.4

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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