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STRATEGY WEEKLY

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Europe tries solidarity

Key Points

- **Macron and Merkel announce a recovery fund worth €500b**
- **Renewed tensions between the US and China, Hang Seng plunges**
- **Peripheral spreads tighten**
- **Credit spreads resumed rallying**

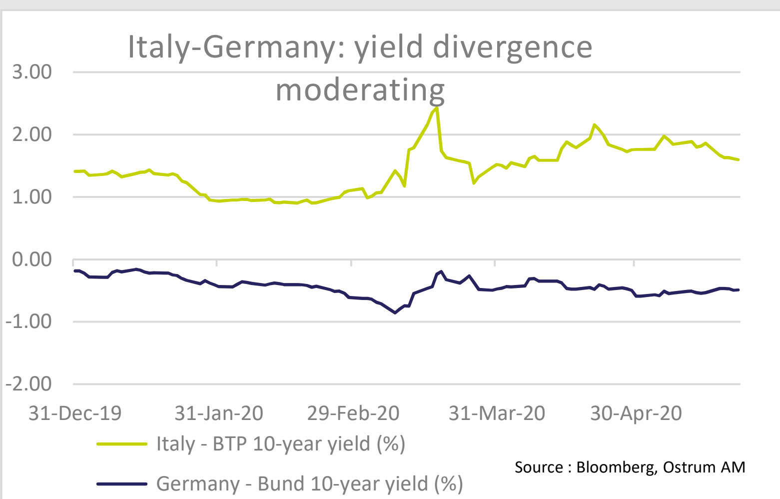
Equity markets remain well oriented thanks to policy support. Renewed tensions between the US and China and the US weighed on stock prices late last week. The S&P closed last week above 2950.

The French-German proposal for a European plan sparked a tightening in peripheral bond spreads. BTP spreads hover about 210bp compared with 320bp at the height of the crisis.

IG credit is also well oriented despite large bond issuance volumes. IG spreads have fallen within 200bp in Both Europe and the US. High yield benefits from reach for yield despite a challenging economic environment in several sectors.

Emerging debt continued to rally towards 535bp against US Treasuries. The euro reacted positively to the Marcron-Merkel initiative by regaining ground against the US dollar. The single currency still trades below $1.10.

Chart of the week



The French-German initiative puts the onus on solidarity in Europe. Transfers included in the 500b plan will ease financial pressure on countries that are most affected by the sanitary crisis.

Italy and Spain may receive amounts topping 100b between 2021 and 2027. Grants have the potential to reduce bond issuance plans all the more so that ESM will bring credit line to the tune of 2pp at favorable terms.

Whilst the growth outlook remains dire, the financial constraint is easing somewhat.

China tightens its grip on Hongkong

Financial markets reacted to renewed tensions between China and the US last week. The Hang Seng index plunged by more than 5% last Friday, Shanghai lost 2% and western markets gave up 1%. Beijing adopted a security law for Hongkong that drew criticism from the US. Independence of the Chinese administrative region is key to ensure that Hongkong retains preferential treatment from the US. Should Hongkong's status be jeopardized, there would be an additional hurdle to a recovery in global trade. Furthermore, China will clearly be a factor in the upcoming US Presidential elections. Political risk, put aside during the global pandemic, may spark volatility bouts over the coming months.

The week had started on a positive note in financial markets thanks to promising tests of a Covid-19 vaccine in the US and a boost from the Macron-Merkel proposition of an ambitious recovery fund. Emmanuel Macron and Angela Merkel presented a €500b plan to support regions and sectors that are most affected by the sanitary crisis. The fund will be funded by contributions from member states and EU borrowing. If agreed, the plan will be included into the 2021-2027 EU budget. EFSM would issue bonds guaranteed by EU member states. The French-German project includes transfers, which does enhance support to most-affected countries. Several countries from Northern Europe have made a counterproposal based on loans instead of grants. According to early estimates based on GDP per capita and the size of the tourism sector, Italy may receive as much as 150b between 2021 and 2027. Spain will benefit from grants to the tune of €115b whilst Portugal and Greece would get anywhere between €20 and €25b.

Rally in peripheral bonds

Bund yields have crept higher by about 5bp across all maturities last week. Solidarity across European nations has been weighing on Bunds to some extent. Bund yields surpassed -0,50%. However, peripheral bond spreads have tightened by 20-30bp in the past week. BTP with 10 years maturity are trading about 210bp. The improved sentiment on Italian bonds also showed in strong investor interest for 5-year BTP Italia (€22.3b demand). The Italian government will likely tap the ESM credit line. Financing conditions (10-year loan at swap plus 10bp) and the attached conditionality are extremely favorable. Spain may also benefit from the ESM credit facility which provides much cheaper funding than current market conditions for Bonos.

In US bond markets, the Treasury reopened the 20-year maturity note. The transaction temporarily weighed on the back end of the curve. The 5s30s spread widened since emergency cuts in March beyond the 100bp threshold. FOMC minutes revealed discussions among policymakers regarding a yield curve control policy. Such policy may reduce volatility of the term structure. Final investors continue to accumulate holdings as evidence by inflows into US Treasuries ETFs. Conversely, spreads on mortgage-backed securities remain under pressure given the downturn in housing. MBS spreads stand at 73bp for a limited duration of less than 2 years.

US credit spreads below 200bp

Corporate credit offers a favorable risk-reward tradeoff. Corporate bond issuance clearly accelerated of late totaling more than $1T year-to-date. Activity in primary markets had slowed the rally in spreads but new issue premiums are now falling (in Europe as well). The average spread on IG credit stands at 186bp last week. The Fed has started to buy corporate bonds to the tune of 1.8b focusing on debt with maturities within 5 years. Rates on commercial paper markets are back to normal below the 0.25% mark. However, short-term bond spreads remained relatively elevated relative to 5-year bonds. There is hence some steepening potential in credit curves. In parallel, high yield (680bp) benefits from reach-for-yield, all the more so since the Fed began investing in credit ETFs. In Europe, ECB intervention continues to support credit spreads but competition from peripheral sovereign bonds has reduced tightening pressure on corporate bond markets. The pickup in final flows is less obvious than in the US but the level of spreads in the asset class is similar.

Equity markets remain buoyed by unprecedented monetary easing (Fed balance sheet hit $7T) and an 'expectations bubble' implying a V-shaped recovery. Earnings will plunge in the second quarter in keeping with the sharp contraction in economies. Speculative accounts are accumulating short positions which may reflect anxiety regarding elevated valuation multiples (>21x 2020 EPS). Major indices in both Europe and the US have been stuck in a trading range since early April. Yet the S&P 500 is closing in on the 3000 mark. Cautious consensus has been caught off guard by incoming news of vaccine being tested. That said, retesting the lows looks unlikely even at this juncture even as potential upside could prove limited if activity fails to firm up.

As regards emerging markets, selling flows have abated and spreads have indeed come in strongly by more than 100bp since the peak. Dollar declines are all beneficial to the asset class, as the greenback is a risk-on/risk-off parameter. Accumulation of speculative positions on the Japanese yen nevertheless hints at a possible rotation into other traditional safe havens.

Main Market Indicators

G4 Government Bonds	25-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.68 %	+1	+3	-8
EUR Bunds 10y	-0.49%	-3	-2	-31
EUR Bunds 2s10s	19 bp	-4	-5	-23
USD Treasuries 2y	0.17 %	-1	-6	-140
USD Treasuries 10y	0.66 %	-7	+6	-126
USD Treasuries 2s10s	49 bp	-6	+12	+14
GBP Gilt 10y	0.17 %	-6	-15	-65
JPY JGB 10y	0 %	+1	+2	+1
€ Sovereign Spreads (10y)	25-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	45 bp	-2	-5	+15
Italy	207 bp	-7	-24	+47
Spain	110 bp	-10	-32	+45
Inflation Break-evens (10y)	25-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	33 bp	+6	+2	-
USD TIPS	111 bp	-6	0	-67
GBP Gilt Index-Linked	288 bp	+5	+15	-24
EUR Credit Indices	25-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	186 bp	-13	-15	+93
EUR Agencies OAS	66 bp	-7	-13	+22
EUR Securitized - Covered OAS	54 bp	-7	-18	+12
EUR Pan-European High Yield OAS	637 bp	-43	-41	+333
EUR/USD CDS Indices 5y	25-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	80 bp	-5	-2	+36
iTraxx Crossover	479 bp	-25	-14	+273
CDX IG	87 bp	-4	-4	+42
CDX High Yield	617 bp	-31	-38	+337
Emerging Markets	25-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	536 bp	-43	-101	+245
Currencies	25-May-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.089	-0.14	+0.67	-2.98
GBP/USD	$1.219	+0.09	-1.7	-8.08
USD/JPY	¥107.69	-0.39	-0.37	+0.83
Commodity Futures	25-May-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$35.2	$0.4	$10.4	-$28.2
Gold	$1 729.6	-$1.5	$17.2	$206.8
Equity Market Indices	25-May-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	2 955	3.20	4.18	-8.52
EuroStoxx 50	2 961	1.67	5.40	-20.95
CAC 40	4 517	0.42	2.83	-24.43
Nikkei 225	20 742	3.02	7.68	-12.32
Shanghai Composite	2 818	-2.00	0.34	-7.61
VIX - Implied Volatility Index	28.16	-11.70	-21.63	104.35

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