Ostrum
ASSET MANAGEMENT

MyStratWeekly
Market views and strategy

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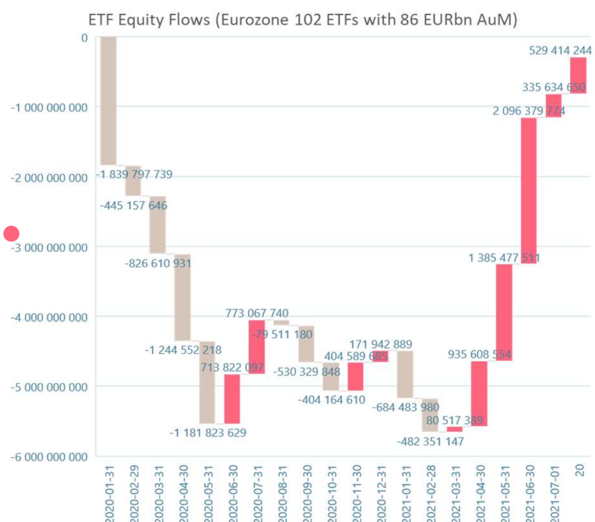
Market review: back to school!

- **After the summer break, MyStratWeekly is back. For this first issue we offer a detailed review of the summer markets. The thematic part will be back next week.**
- **Jackson Hole's date was obviously in everyone's head. J. Powell has so far distilled evidence of an upcoming decline in the monthly asset purchase program, which could start in Q4 2021. A linear decline seems to be the assurance of minimal impact on market volatility.**
- **The ECB is at cruising speed with a QE that continues and has helped to maintain very stable Bund and peripheral rates. The Board of Governors is also considering the post PEPP period, a major topic, although information on the issue should not be expected in the coming months, with the decision to take place in March 2022.**
- **In this environment of crushed volatility, risky assets performed well, equities are up and credit spreads were very stable.**
- **However, still waters run deep, the signs of nervousness, or at least caution, of the market are accumulating. With tense valuations, even extremely tense in some cases, and growth that has clearly passed its peak, it is indeed difficult to find reasons for a second wind of the markets.**

Chart of the week



The rebalancing of the portfolios towards interest rates took place in July. The purchase of the "Eurozone Fixed Income" ETFs has been significant since April.

Nevertheless, the purchase of European shares continues. As often, Europe is lagging the United States. Demand therefore remains strong and continues to support European equity markets.

The volume of purchases over the past few months is offsetting the drop in the first half of last year during the Covid episode.

Figure of the week

-1.08

The 10-year real interest rate have declined after Jackson Hole and are comfortably below -1%. Financial repression is alive and well.

Source : Ostrum AM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Topic of the week

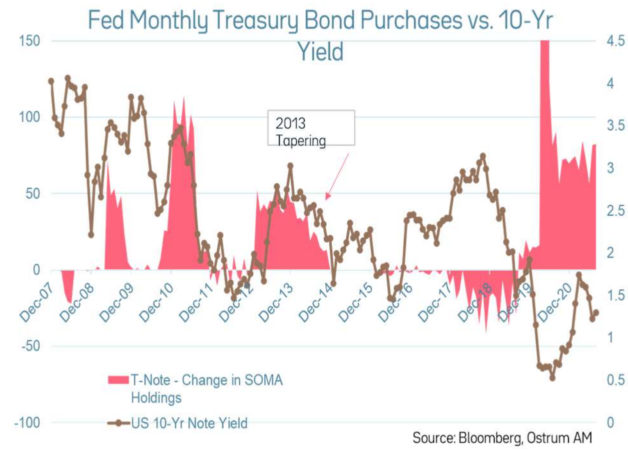
Back to school

After the summer break, MyStratWeekly is back. For this first issue we offer a detailed review of the summer markets. The thematic part will be back next week.

Monetary policies continue to dictate bond market trends

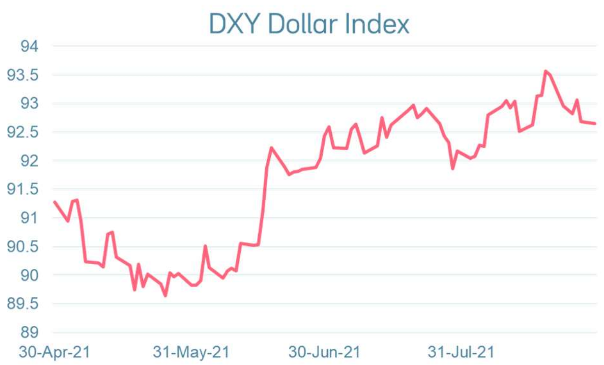
Over the summer, fixed income markets moved further away from economic fundamentals. The yield on US T-note remains anchored below 1.4% by a Fed that is desperately seeking a smooth way out of an accommodative monetary policy that is now clearly out of line with economic reality. Inflation above 5% is starting to weigh on household confidence. The transitory nature of the rise in prices is being debated while the tensions in the global supply chains do not seem to be easing. Strong growth in the United States is barely disturbed by the emergence of the delta variant. Asset prices are generally seen as excessive.

The Jackson Hole symposium was obviously on every market participant's mind. Several non-voting FOMC members (including Bullard, George, Kaplan) already called for an early reduction in monetary support. The Fed still buys $ 80 billion in Treasuries and $ 40 billion in mortgages each month. Jerome Powell has so far distilled hints of an upcoming decrease in the monthly asset purchase program. The tapering of Fed asset purchase could start in 4Q 2021. A linear decline in market operations may be needed to ensure that that the impact on market volatility turns out to be minimal. Indeed, the surprise announcement by Ben Bernanke in May 2013, although well upstream of the effective reduction in quantitative easing, had caused a sharp rise in rates from 1.6% to 3% on the US 10-year bond.



The inevitable language precautions helped to keep the term premium very low in the US interest rate markets. At the end of August, the US bond term premium had even turned negative again by 17bp according to the estimates of the New York Fed. The Afghan crisis partly explains the reach for security expressed by the buybacks of Treasuries. However, it also seems that the Fed is struggling to convince stakeholders of its medium-term Fed Funds rate projections. Implied short-term forward rates peak at 1.75% while the Fed maintains a projection of 2.5%. At the same time, the fiscal situation is not without impact on the fixed income markets. The suspension of the debt ceiling ended on July 31. The borrowing capacity of the US federal government is constrained. The Treasury is forced to draw on its cash holdings to fund federal spending worth around $ 600 billion per month. The Treasury account stood at $ 310 billion at the end of August. The objective is to maintain a cash flow of around $ 800 billion in growth speed from now on. The Treasury is resorting to extraordinary measures to finance its spending ... but will no longer have visibility beyond mid-October. The specter of a technical default will resurface. The use of cash reserves thus reduces the outstanding T-bills available to market participants and consequently generates a massive excess of liquidity in MMFs and banks. These funds are naturally placed on risk-free assets or return to the Federal Reserve through the Fed's reverse repo facility. The amounts redeposited are considerable so that the search for collateral totals, at the end of August, more than $ 1.135 trillion. This is the main pitfall of quantitative easing programs, which together create both excess liquidity and asset shortages and long-lasting valuation distortions.

The impact of excessively accommodative monetary policy was undoubtedly amplified by a widespread bearish consensus, no doubt motivated by the frantic rise in the stock markets and the improvement in the economic situation. Final investors, caught wrong-footed, had no other option but to hedge their losses in the rising market by buying back their short positions. We are also observing a bounce in the US dollar visible through a clear resurgence of buying interest in Treasuries from the non-resident official sector. The dollar held up well over the summer ($ 1.175 as of August 26), perhaps also because of the delay in adopting the fiscal programs that the Biden Administration is pushing for. Infrastructure spending will be split into two separate bills to accommodate the complexities of the US budget process.



Source: Bloomberg, Ostrum AM

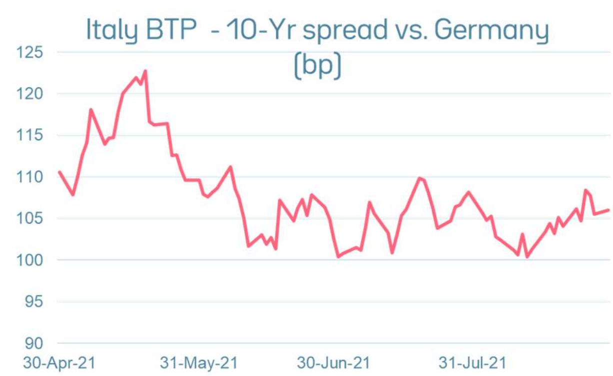
Inflation deemed transitory by the Fed remains a central theme for US bond markets. Rising prices for durable goods are now clearly weighing on consumer confidence. The cost of housing, which has been rising steadily for 18 months, reduces access to homeownership and, ultimately, increases rents. Pressure on energy prices (natural gas) is also returning. While inflation likely peaked at 5.4% in July (CPI), corporate behavior is changing so that selling prices are now adjusting to continued cost pressures. Market break-even rates have changed little but remain at the top of the range observed since the spring. Indeed, 10-year inflation swaps hover above 2.5% in August.

The US T-note rally also set the tone for Bunds over the summer. Balanced fund managers also largely reallocated the profits made on the equity markets in the first half of the year into bond markets. The German Bund returned to very low levels close to the deposit rate set at -0.50%. However, the German debt agency was the only one active in August in a primary market largely deserted by sovereign issuers. Admittedly, Bund yields did not plummet to its deadly summer 2019 levels (below -0.80%) but this drop is inconsistent with evidence of the continued economic upturn and higher inflation recently (2.2 % in July). Early fears related to the delta variant have proven misplaced according to surveys. Despite the favorable backdrop, the ECB continues to hammer out its accommodating rhetoric. Chief economist Philip Lane promptly pointed out the ECB's capacity to intervene if the much-anticipated Fed tapering spills over to euro area bond markets. The attractiveness of European fixed income markets has deteriorated, as non-resident investors seem to be fleeing negative euro yields mainly in favor of Treasuries. The concern is measured given the very low level of rates and spreads.

The reformulation of the inflation target, now symmetrical around 2%, also suggests an extension of the accommodative policy over the course of several years. The Board of Governors is also reflecting on the post-PEPP. The inclusion of climate-related risks and its potential impact on prices and financial stability should materialize through a new asset purchase plan and a reorientation of the redemption payments from credit holdings, particularly towards green bond issues.

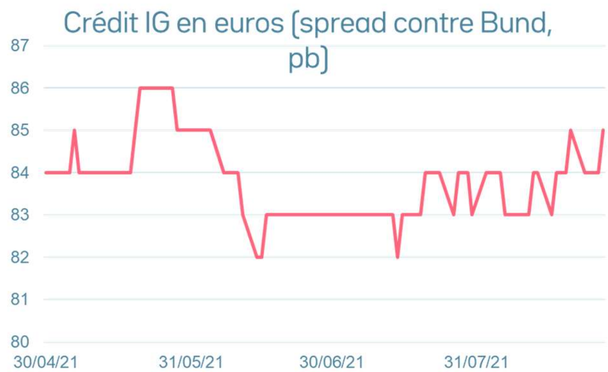
Apart from the Bund rally, sovereign debts performed well this summer despite a reduction in the long consensus on peripheral debts. Excess liquidity keeps squeezing risk premiums, so that Greece, for example, trades at spreads close to those of Spain on long maturities.

The first disbursements of the European recovery program have been made. Only Italy and Greece will require the full amount of loans and grants, but other countries (Portugal, Poland, Cyprus…) will borrow part of the amounts offered by the EU. Spain is leaving itself until 2023 to apply or not for these European loans. Spreads remained broadly flat over the summer. Italian 10-year BTPs traded within a narrow range between 100bp and 110bp in July-August. With the delta spread apparently under control, the resumption of growth should result in an improvement in public finances and thus a reduction in future borrowing needs. Sovereign issuers are generally well advanced in their annual programs as EU funds and improved tax revenues reduce the risk of stress on bond spreads. Credit ratings could improve as well, with Greece in particular likely to see its rating raised a notch in the fall. However, the ECB will have to review its criteria for inclusion in the APP to maintain its purchases of GGBs beyond March 2022. We can bet that the institution will find a way to maintain favorable financial conditions.



Source: Bloomberg, Ostrum AM

ECB action continues to keep credit spreads under wraps. The European investment grade premium has remained virtually unchanged since June around 85bp. With the primary market coming to a virtual standstill during the summer, the ECB was able to reduce its purchases in August. However, the phenomenon of the scarcity of available bonds remains and will tend to worsen in the latter part of the year. Negative yields remain a major brake on investment in credit by a majority of institutional investors. The flow of debt repayments from non-financial companies should be higher than bond issues over the last four months of the year.



Source: Bloomberg, Ostrum AM

The high yield primary market remained more active compared to investment grade. Quarterly earnings releases tend to occur later than in the investment grade universe and investor appetite for yield seems insatiable. Primary market activity is also much higher than in previous years and, despite outflows from high yield funds, new issues continue to be placed. The total issues this year could reach 100bn €, a historic record. It appears that the ECB's CSPP has the collateral effect of shifting institutional demand towards riskier ratings. This is made possible by the recovery in cash flows and a particularly low default rate coming out of an unprecedented recession. The 12-month default rate on high yield issuers remains below 2%. Spreads on speculative-grade bonds remain within 300bp vs. German Bunds with, however, more buoyant momentum on the highest ratings (BBs) most likely to regain an investment grade rating as the economic recovery unfolds. A form of decompression in risk premiums continues slowly, but the backdrop remains solid overall in the high yield segment.

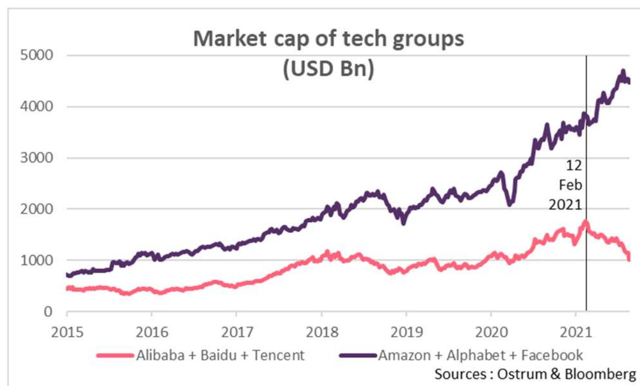
Equity market, not so optimistic

The results of the two summer months are quite positive for all the world stock exchanges. The MSCI World is earning more than 3% and the majority of the world stock exchanges are up.

Fundamentals continued to support markets with economic data confirming the recovery even though they were much less upbeat than in previous months. The results season was also very good, on the EuroStoxx index the turnover is 4.5% above expectations while profits are 31% higher.

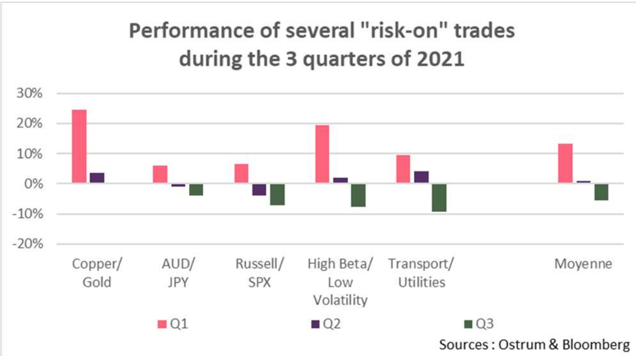
It is interesting to note that the margins held up very well, which explains the surprises on profits. This is despite the increase in input prices for companies that should have played in the opposite direction. It is therefore a sign that companies could have pass this increase on their finished products and that they therefore have enough pricing power. It is also a sign that inflationary pressures are spreading and are having an impact on the final consumer.

The exception comes of course from China, where the indexes have slipped, especially as a result of regulatory decisions on tech giants. It should be noted, however, as the chart below shows, that the underperformance of this sector started before.

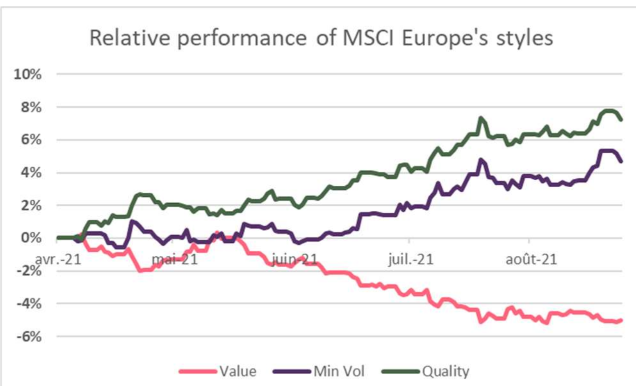


However, we think it is appropriate to present also the opposite of this somewhat idyllic picture. If the markets, on the surface, seem positive, in a very «risk-on» atmosphere, some details show a much more nervous attitude.

Let's start with a number of investment positions that should normally perform well in a "risk-on" period. The chart below shows that all of these positions performed very well in the first quarter of this year, they returned almost zero in the second quarter, and they all had a negative performance since early July. It seems, therefore, that these markers of market psychology send a much more measured, even anxiogenic, message.

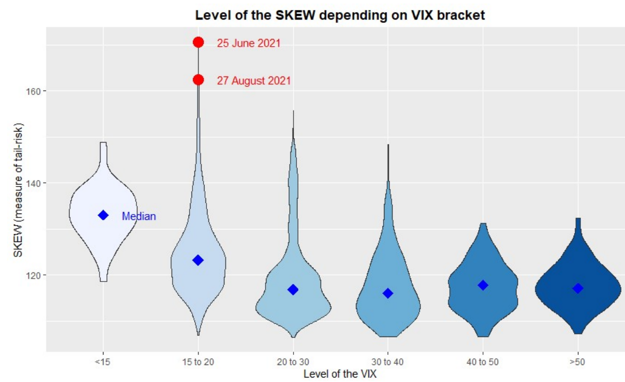


Similarly, while the equity markets performed well, the typology is much more "risk-off". The two styles "low-volatility" and "quality" had a very marginal relative performance over this year's Q2 but they have been in high demand since July. A clear symptom of a market that seeks safety. On the other hand, the value stocks that the market applauded during the upswing phases of economic recovery or optimism, experienced the opposite path with a relatively negative performance over the past two months. This is also a sign that the market penalizes the most risky stocks.



Finally, volatility remained very low during the summer. The VIX has passed the 20% mark but is rapidly decreasing and the volatility achieved on all asset classes is significantly lower than its long-term average (with the notable exception of commodities where the volatility recorded over the last three months is close to normal).

However, here too, a careful reading gives a more contrasting picture. While the VIX remained very calm, the SKEW hit a record high at the end of June and remains at unusually high levels. The VIX measures the expected volatility on the S&P 500, the SKEW is an extreme volatility price. The market is therefore positioned both for a calm market (hence the central scenario is very encouraging), but also for a significant correction risk (the negative alternative scenario is increasingly likely). The zen-attitude of the market is therefore only true on the surface.



Conclusion

The markets remained rather calm during the summer. The major event, as expected, was J Powell's speech at Jackson Hole. Successful to the extent that it confirmed the imminence of tapering without creating a "taper tentrum". At the same time, the ECB remains on a very accommodative policy, which has helped to stabilize the Bund as well as the peripheral gaps.

In this environment of crushed volatility, risky assets performed well, equities up and credit spreads were very stable. However, still waters run deep, the signs of nervousness, or at least caution, of the market are accumulating. With tense, if not extremely tense, volarisations in some cases, and growth that has clearly passed are high points, it is indeed difficult to find reasons for a second breath of markets.

Axel Botte, Stéphane Déo

Main market indicators

G4 Government Bonds	30-Aug-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.74 %	+1	+3	-4
EUR Bunds 10y	-0.42%	+6	+4	+15
EUR Bunds 2s10s	32 bp	+5	+2	+19
USD Treasuries 2y	0.22 %	-1	+3	+10
USD Treasuries 10y	1.3 %	+6	+9	+40
USD Treasuries 2s10s	108 bp	+6	+5	+30
GBP Gilt 10y	0.58 %	+6	+2	+38
JPY JGB 10y	0.02 %	+0	+0	+0
€ Sovereign Spreads (10y)	**30-Aug-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	35 bp	+1	0	+12
Italy	107 bp	+0	-2	-5
Spain	71 bp	+0	-2	+10
Inflation Break-evens (10y)	**30-Aug-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	141 bp	+3	+0	-
USD TIPS	239 bp	+11	-1	+41
GBP Gilt Index-Linked	364 bp	+8	+11	+64
EUR Credit Indices	**30-Aug-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	85 bp	+0	+1	-7
EUR Agencies OAS	43 bp	+0	-1	+2
EUR Securitized - Covered OAS	37 bp	-2	-2	+4
EUR Pan-European High Yield OAS	297 bp	-5	-11	-61
EUR/USD CDS Indices 5y	**30-Aug-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	45 bp	-1	-1	-2
iTraxx Crossover	230 bp	-3	-6	-11
CDX IG	46 bp	-2	-3	-4
CDX High Yield	275 bp	-9	-14	-18
Emerging Markets	**30-Aug-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	347 bp	-8	-13	-5
Currencies	**30-Aug-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.180	+0.5	-0.61	-3.49
GBP/USD	$1.376	+0.26	-1.06	+0.78
USD/JPY	¥109.89	-0.11	-0.15	-6
Commodity Futures	**30-Aug-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$72.8	$4.0	-$2.6	$21.7
Gold	$1 816.9	$13.7	$2.7	-$77.4
Equity Market Indices	**30-Aug-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 509	1.52	2.60	20.06
EuroStoxx 50	4 199	0.53	2.67	18.18
CAC 40	6 694	0.17	1.23	20.58
Nikkei 225	27 789	1.07	1.85	1.26
Shanghai Composite	3 528	1.47	3.85	1.59
VIX - Implied Volatility Index	16.39	-2.80	-8.61	-26.73

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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