MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

N° 036 // **September 13, 2021**

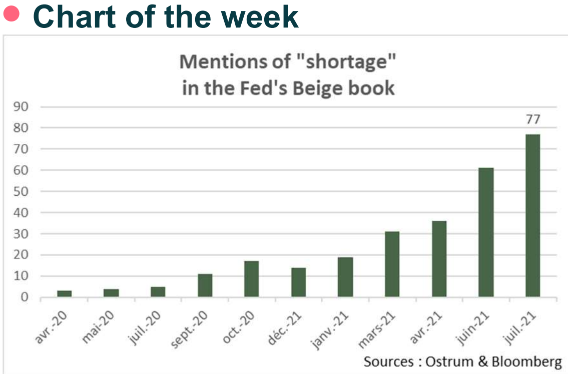
Topic of the week: EM after Jackson Hole: no tantrum but concerns

- **J. Powell's careful communication to Jackson Hole has avoided a tantrum for emerging markets;**
- **However, three concerns remain for emerging markets: accelerating inflation, weak economic margins of maneuver, and low vaccine accessibility, exacerbate the divergence with developed markets;**
- **For an investment perspective, the divergence between zones and countries is an important element to take into account.**

Market review: ECB: *rendez-vous* in December

- **Lagarde announces a deceleration in PEPP purchases;**
- **Few movements on rates but inflation worries;**
- **Very low volatility on sovereign and credit spreads;**
- **The S&P index records five straight down sessions.**

Chart of the week



The Beige book is a collection of economic anecdotes collected by the regional Feds.

It is interesting to note the number of instances of the word "shortage": 77 times in the last edition of the Beige book and the trend is very clearly upwards.

This echoes what business surveys tell us, the delivery times are surging, and the shortage problems are penalizing an increasing number of sectors.

Figure of the week

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Source : Ostrum AM

In billions of dollars, the additional cost to insurance companies generated by climate risk by 2040.

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● **Topic of the week**

EM after Jackson Hole: no tantrum but concerns

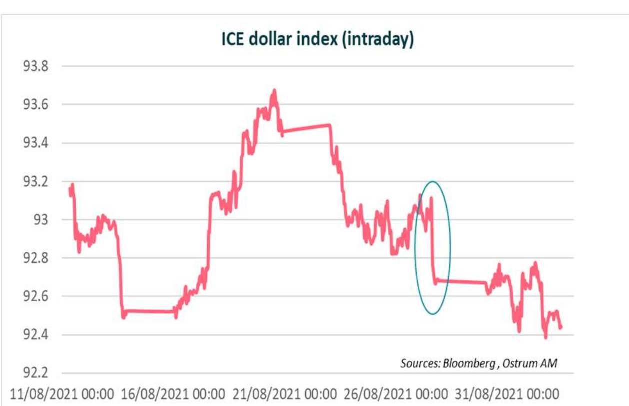
The speech of J. Powell on August 26-27 in Jackson Hole was highly anticipated by investors who were scrutinizing clues on the next "tapering". The Fed's prudence in this regard has provoked a "dovish" reaction from financial markets, particularly emerging ones. Even if the Fed slows down the pace of its purchases of financial assets, it should not do so abruptly so as not to provoke shocks on the financial markets or on its economy. Liquidity will remain abundant, providing support to emerging markets.

Jackson Hole Emergent Response: "Dovish"

International investors had a rather "dovish" reaction, reflecting the weakening of the dollar that followed J. Powell's August 26-27 speech at Jackson Hole.

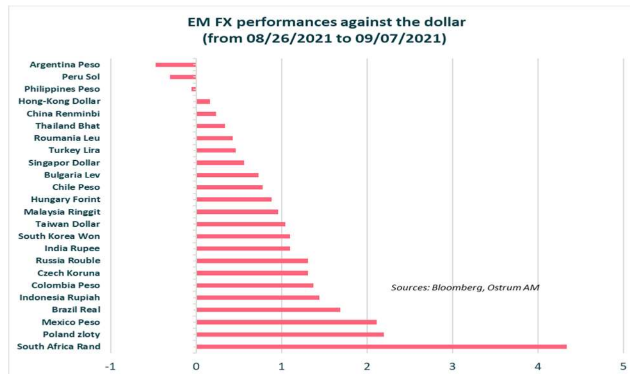
1/ Changes in currencies

This "dovish" reaction can be seen on the chart below which shows the intra-day movements of the ICE dollar index (dollar index against a basket of the six main currencies, EUR, JPY, GBP, CAD, SEK and CHF).



This means that investors were expecting more hawkish announcements from the Fed governor. This was not the case: even if the Fed slows down the pace of its purchases of financial assets, it should not do so abruptly so as not to provoke shocks on the financial markets and on its economy. As a result, liquidity will remain abundant and will continue to support risky assets, including emerging markets.

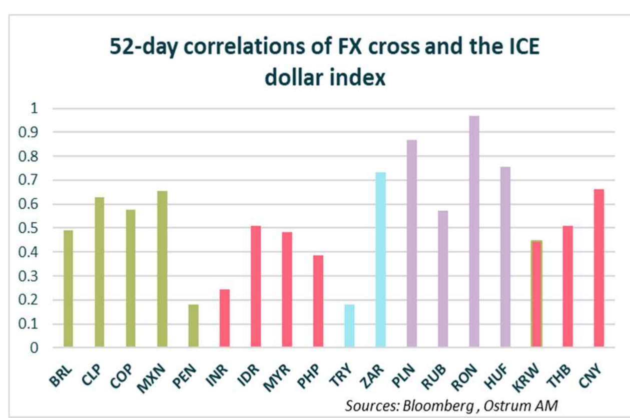
The weakening of the dollar has benefited the currencies of emerging countries, as reflected in the chart below which represents the performance of emerging currencies against the US dollar since the speech of Jackson Hole on August 26.



The South African rand is the currency with the best performance (+4.3%) against the greenback since Jackson Hole, while it was previously among the currencies that had depreciated the most (-6.0%) because of social tensions that had erupted in the country.

The rand has been imitated by many Latin American currencies and also by currencies whose central banks have raised their key interest rates, as was the case recently with Chile, which surprisingly raised its key interest rate by +75 bps to 1.5% due to the acceleration of inflation.

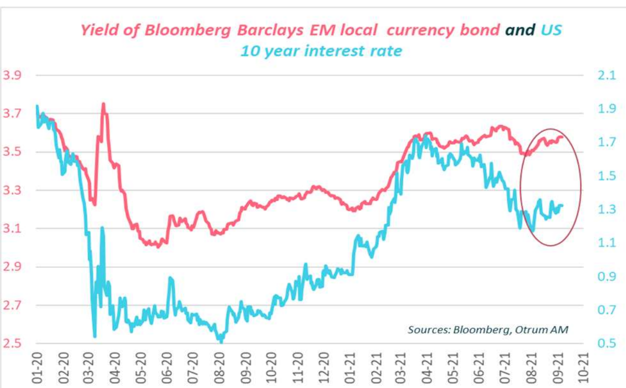
However, the performance of EM currencies is not solely due to the behavior of the dollar. Country-specific factors should also be taken into account when explaining their performance. The chart below shows the correlations of the crosses against the dollar and the ICE dollar index.



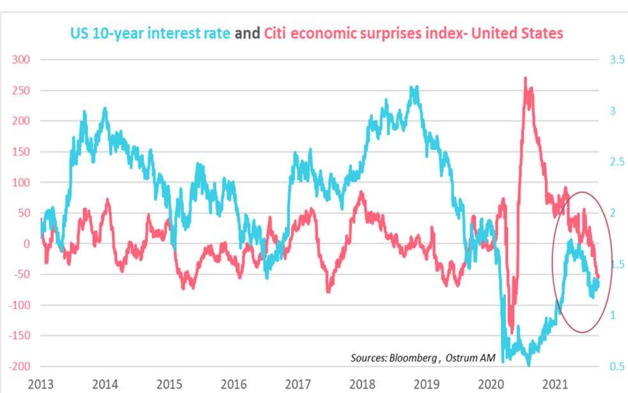
This is the case of the Peruvian sol (PEN) which recorded the worst performances against the dollar (after the Argentine peso) since the beginning of the year at -11.8%, because of the high uncertainty that had weighed on the results of the presidential election of April 6. It took a month and a half to find out the results! We can also mention the Turkish lira (TRY), which is very sensitive to President Erdogan's statements on the central bank's monetary policy. The president wants to lower key interest rates to support the business and increase his popularity.

2/ Interest rate developments

The other important point is that over the recent period (circled in the chart below) local EM rates have remained relatively stable and have not kept pace with the US 10-year interest rate as seen at the beginning of the year[1].

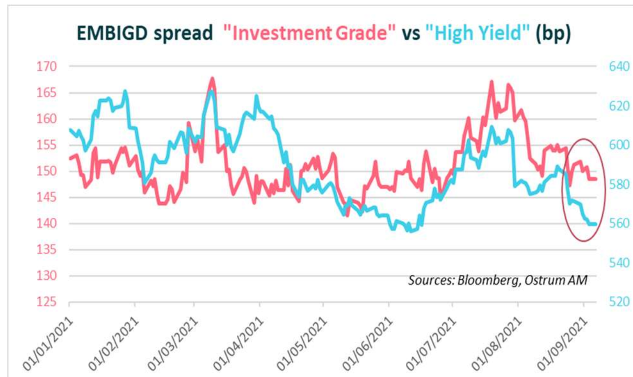


The explanation comes from the American dynamics. The graph below shows the fall in the Citi indicator of US economic surprises compared to the beginning of the year, it translates into a fall in the US 10-year interest rate, which remained below 1.4% throughout the summer. This factor is currently relegated to the background by investors.



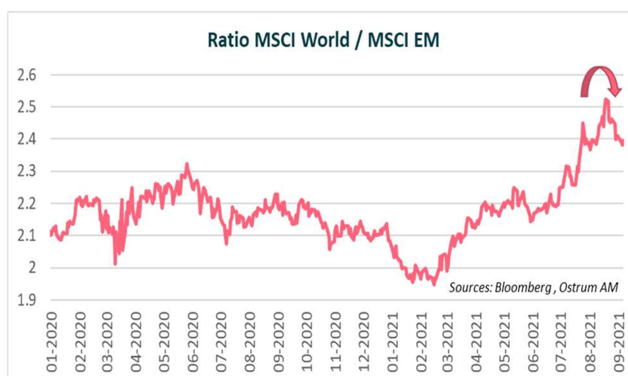
The spread of the JPM EMBIGD index has changed little since the FOMC of June 16. It widened from +11bps to 340 bps, and the movement essentially reflected the directional US interest rates.

The impact of J. Powell's "dovish" discourse was immediate on the EMBIGD spread for so-called "high yield" countries, which quickly tightened from -20bps to 560 bps, the lowest level since February 2020, as can be seen in the chart below.



On the equity markets, the reaction was also "dovish" on the MSCI EM Index, which reached a year-low on August 20 due to regulatory decisions taken by China (which represents 40% of the index) on its technology giants.

We note a 4.7% rebound in the index following Jackson Hole, but especially the reversal of the MSCI World/MSCI EM ratio (chart below) which shows a recent outperformance of EM equities.



This ratio had risen sharply since the beginning of the year, reflecting the "trade reflation" that had benefited the equity markets of developed countries.

[1] *MyStratWeekly* du 26/04/2021: "Emerging; at a crossroads"

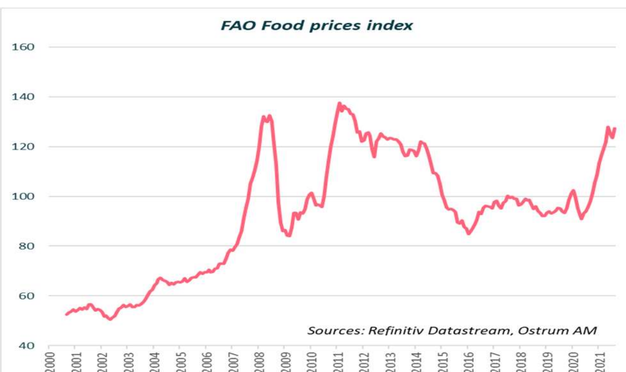
The reversal in the wake of Jackson Hole reflects an improved growth outlook for emerging markets, linked to the Fed's cautious stance that does not create tensions in emerging markets that could penalize their recovery.

Three concerns remain

Despite a "dovish" response from emerging markets to J. Powell's speech at Jackson Hole, three concerns remain for emerging markets: inflation, weak flexibilities to support vaccine activity and accessibility. This may exacerbate the divergence of activity between developed and emerging countries.

1/ Faster inflation linked to rising food prices

The acceleration of inflation linked to rising food prices is the most worrying point: the FAO Food Price Index has increased by 12.5% since the beginning of the year and has reached 2008 levels, when the hunger revolts had erupted in emerging countries, especially in the poorest ones.



Food has a significant weight in the consumer price indices (CPIs) of emerging countries. On average, food accounts for 25% and energy for 10% of CPIs. These weights also vary by country. In India, the weight of food is 45% and 40% for the Philippines.

The acceleration of food prices is therefore problematic for emerging markets as it accelerates inflation while threatening their political and social stability.

The difference with 2008 is that this time, the rise in food prices is also accompanied by a loss of household income in many emerging countries.

Until now, remittances from migrant workers have helped to avoid social tensions. These funds enabled the most vulnerable families to maintain their purchasing power despite rising food prices.

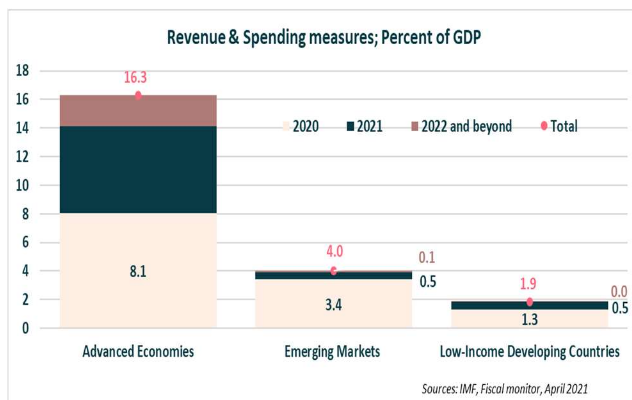
The exceptional financial measures, linked to the pandemic, and intended for households and businesses in developed countries had made it possible to keep these funds at high levels, which was a good surprise during this crisis. The World Bank projects the amount of these funds to be $553 billion by 2021, or +2.6% compared to 2020, linked to the new epidemic wave that hit emerging countries and which required financial assistance from the diaspora. However, the gradual lifting of these exceptional financial measures in developed countries should reduce the financial support of the diaspora.

On the other hand, economic sectors continue to be penalized by the health crisis in many emerging countries, particularly those whose economies depend heavily on tourism, which has destroyed many jobs and incomes.

2/ The weak margins of maneuvers aggravate the divergence of activity between developed and emerging

Fiscal support continues in developed countries, while it decreased significantly in 2020 in emerging countries and is virtually non-existent in poor countries.

The chart below shows that, in total, between 2020 and 2022, fiscal measures represent 16.3% of GDP for developed markets and only 4.0% of GDP for emerging markets, of which 3.4% expired in 2020. These represent 1.9% of GDP for poor countries.



Emerging countries are looking to rebuild fiscal margins. Higher commodity prices have helped both producing and exporting countries. However, some countries such as Brazil, Hungary, Mexico, Chile and Russia have begun to raise their policy rates to curb the acceleration of inflation, which reduces the room for monetary maneuver to support activity.

The IMF's historic allocation of $650 billion in Special Drawing Rights (SDRs), including $275 billion for emerging markets, will not spontaneously change the long-term economic prospects of emerging countries.

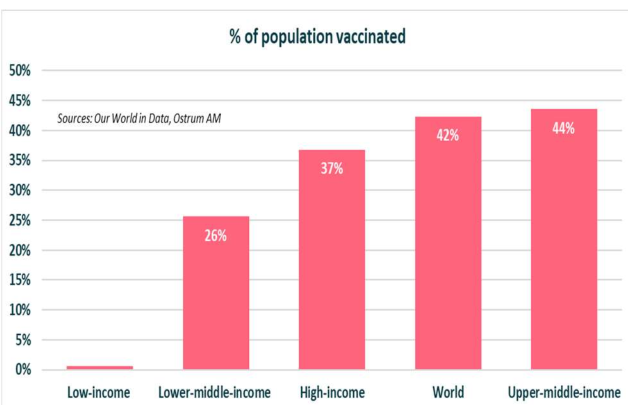
SDR allocations give countries the right to access dollars at virtually no cost without an IMF program that would be allocated in exchange for strong conditionalities. The SDRs were distributed to member countries according to their voting rights at the IMF. However, for large emerging countries, the increase in reserves from the allocation of SDRs is too small to change their economic outlook.

The situation is different for other already very fragile countries such as Argentina ($3.05 billion, or 1% of GDP), where the allocation of SDRs will help delay the IMF programs they need. The SDRs will facilitate the financing conditions for some countries in difficult economic conditions.

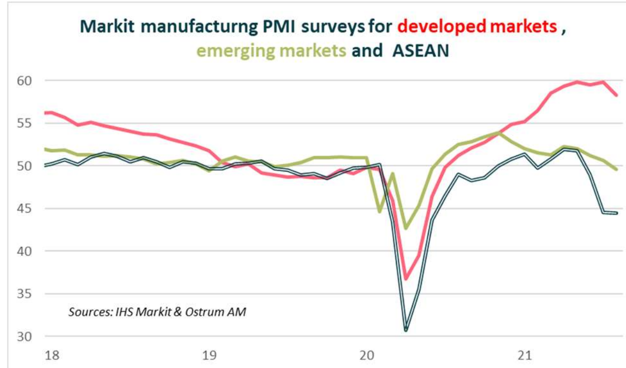
In Sub-Saharan Africa, the amounts received are significant in relation to GDP in only a few countries, such as Zambia (7.2% of GDP), Jamaica (3.7% of GDP) and Seychelles (3.3% of GDP).

3 / Vaccine Accessibility

The graph below shows that 44% of the population of the highest middle-income countries (which correspond to the majority of emerging countries) is vaccinated, against only 1% for low-income countries.



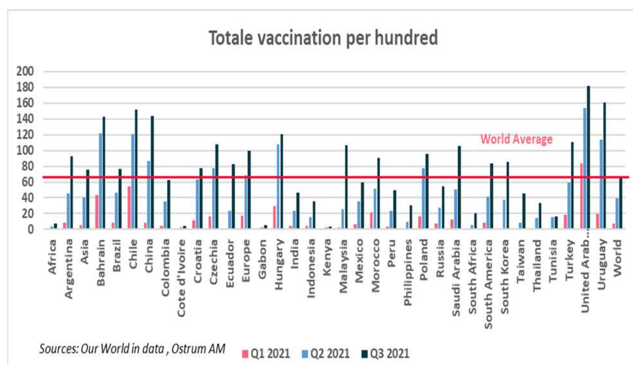
The low availability of vaccines for emerging countries and the new wave of Covid-19 epidemics have led to increased divergence of activity between developed and emerging countries. This was further accentuated in August, as were the Markit/PMI surveys in the manufacturing sector, particularly for South-East Asia (chart below).



The inflection of the survey for emerging countries is linked to China, where mobility restrictions put in place to curb the new epidemic wave that hit the south of the country, have slowed the recovery of activity.

In South East Asian countries, strict restrictions have led to a dip in economic activity, reflecting also the distortions of production chains caused by population containment measures.

However, one positive point is to mention: the acceleration of vaccination in many emerging countries in Q3 as shown in the chart below.



Many emerging countries have caught up and surpassed the global average (63 vaccines per 100 population), which is quite encouraging for their economic prospects. This means that the authorities will no longer resort to mobility restrictions which have the effect of severely contracting economic activity.

Our concern remains Africa, where vaccination is still very low at 7.5 vaccines per 100 inhabitants!

The low availability of vaccines reflects structural inequalities, but also intellectual property and production constraints, as well as the limitations of the COVAX scheme (a programme launched by the World Health Organisation for a fair supply of vaccines).

It is an obstacle to the recovery of these countries, which have been hit hard by the economic consequences of the pandemic even before it arrives on their soil and whose room for maneuver is very limited because of their high debt[2].

Conclusion

While the Fed's cautious communication has avoided a "tantrum" on emerging markets, three concerns remain for emerging countries, which risk accentuating divergence in activity dynamics with developed countries. The acceleration of inflation, weak policy room for maneuver and the availability of vaccines are penalizing economic prospects to varying degrees.

Despite the recent good performance of the markets, we must therefore remain cautious; with the IMF's historic allocation of SDRs of $650 billion, including $275 billion for emerging countries, the international financial community is once again at the bedside of emerging countries and at the beginning of the health crisis.

For the investor the divergence between zones and countries will remain an important element to take into account.

Zouhoure Bousbih

[2] *MyStratWeekly* du 02/10/2021 : « Dette émergente en pleine mutation ».

Market review

ECB: *rendez-vous* in December

The announcement of the slowdown in PEPP purchases has had little impact, but inflation risks persist.

The ECB adjusted its monetary policy by announcing a slight decrease in the monthly pace of asset purchases under the PEPP. This unsurprising communication did not lead to significant reactions in the financial markets where the risk-on investor sentiment still prevails. Bund yields rose a modest 2bp last week to -0.35%. Sovereign and credit spreads are broadly unchanged. Western equity markets are treading water, while Asia, buoyed by recovery hopes in Japan, has appreciated 3-4% in five sessions. There is little action in foreign exchange markets, with the exception of the Brazilian real, which was tossed around by local politics.

As regards the US economic backdrop, the US labor market remains in tension. The disappointing net job creation in August (235k) reflects a shortage of labor supply, the number of unemployed persons citing covid-related reasons having jumped from 400k to 5.6 million last month. Thus, the pandemic is further delaying the return to employment of part of the active population. The total of job vacancies reached nearly 11 million in July, while the number of unemployed people did not exceed 8.6 million. Gross monthly hiring, admittedly historically high, capped at 6.1 million in the private sector where recruitment difficulties affect all sectors. At the same time, initial jobless claims continue to decline to 310k, the lowest level recorded since the start of the pandemic. In this context, current economic policy seems unsuitable. The Fed's accommodative monetary policy is unlikely to promote a faster recovery in employment. In essence, economic growth is limited by insufficient supply. These supply constraints led to an acceleration in producer prices to 8.3% over one year in August. Anecdotes reported in the Fed's Beige Book and most business surveys confirm supply difficulties and rising input prices. Consumer price inflation is likely to stay above 5% in August. On the fiscal front, whilst the bipartisan $ 500 billion infrastructure program is to be passed as it is, the second ("human") infrastructure spending plan of $ 3.5 trillion will likely be scaled down. In addition, the reconciliation procedure did not include another suspension of the debt ceiling. The US Treasury estimates that extraordinary measures needed to finance current spending will be exhausted by the end of October. The specter of the federal shutdown could resurface at the end of September.

In the euro area, the ECB announced a reduction in PEPP asset purchases in the months to come. The ECB's cautious language suggests a reduction of 10 to 20 billion € in monthly transactions which have hovered about 80 billion € since the March announcement of an upshift. The rise in inflation is still considered transitory so that the institution expects a return to 1.5% HICP inflation in 2023. In this context, the ECB will undoubtedly announce a review of the current asset purchase programs in December to compensate for the expected end of the PEPP by March 2022. An increase in the APP to 40 or 50 billion € would benefit corporate bond markets, which are under-represented in the PEPP. ECB communication is still a turning point in monetary policy. The policy reshuffling also leaves more room to increase the share of green bonds issued by companies and supranational institutions in the ECB's portfolio. All in all, neither the Fed's communication at Jackson Hole nor that of the ECB will have moved markets significantly.

In the US Treasuries market, last week's auctions were met with solid foreign investor demand. The 10-year and 30-year auctions were well received. The trade coverage ratio on the 30-year T-bond was even at its highest for the year, despite clearing at a yield of 1.91% or 13bp below the August auction. The release of the producer price index, however, caused profit taking at the end of the week and a rise in 10-year break-even inflation rates above 2.40%. The yield curve (2-10 year spread) steepened. The Fed's dubious thesis of transitory inflation will ultimately be tested, but, in the meantime, keeping Jerome Powell's put is probably worth a lie or two. In the euro area, the markets have welcomed the cautious communication from Christine Lagarde. Italian 10-year spreads tightened to a 102bp weekly low. The reduction in deficits in Spain and the successful issuance of the 20-year green Bonos pushed spreads under 70bp.

General anesthesia seems to best characterize credit markets. Euro IG spreads have fluctuated in a narrow range of 2.5bp since June 30th. CDS indices even seem disconnected from the changes in implied volatility. New issue premiums are non-existent despite the return of primary market issuance. The prospect of an increase in APP would further raise the excess demand for credit. High yield (290bp) also remains in strong demand and tightened by 4bp in five sessions. Flows entail yet another testament to the lack of alternatives in an ocean of negative yields.

The US S&P recorded a fifth session of decline while remaining close to historic highs. Pullbacks to 50-day moving averages have been synonymous with a technical rebound this year.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	13-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.7 %	+1	+4	0
EUR Bunds 10y	-0.34%	+3	+13	+23
EUR Bunds 2s10s	37 bp	+2	+10	+24
USD Treasuries 2y	0.21 %	+0	+0	+9
USD Treasuries 10y	1.32 %	+0	+5	+41
USD Treasuries 2s10s	111 bp	0	+4	+32
GBP Gilt 10y	0.74 %	+5	+17	+55
JPY JGB 10y	0.05 %	0	+2	+3
€ Sovereign Spreads (10y)	13-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	33 bp	-1	-1	+10
Italy	102 bp	-4	+1	-9
Spain	66 bp	-2	-2	+5
Inflation Break-evens (10y)	13-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	160 bp	+9	+18	-
USD TIPS	240 bp	+6	+2	+41
GBP Gilt Index-Linked	376 bp	+9	+17	+76
EUR Credit Indices	13-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	84 bp	-1	+1	-8
EUR Agencies OAS	42 bp	+0	+0	+1
EUR Securitized - Covered OAS	37 bp	+0	-1	+4
EUR Pan-European High Yield OAS	289 bp	-3	-8	-69
EUR/USD CDS Indices 5y	13-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	45 bp	+0	-1	-3
iTraxx Crossover	228 bp	+1	-4	-14
CDX IG	47 bp	+0	-2	-3
CDX High Yield	275 bp	+1	-9	-19
Emerging Markets	13-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	341 bp	+0	-9	-11
Currencies	13-Sep-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.180	-0.62	+0	-3.5
GBP/USD	$1.384	+0.03	-0.22	+1.36
USD/JPY	¥109.99	-0.12	-0.36	-6.08
Commodity Futures	13-Sep-21	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$73.6	$1.4	$3.4	$22.7
Gold	$1 791.2	-$32.1	$11.5	-$103.2
Equity Market Indices	13-Sep-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	4 459	-1.69	-0.21	18.70
EuroStoxx 50	4 206	-0.93	-0.55	18.40
CAC 40	6 717	-0.39	-2.60	21.00
Nikkei 225	30 447	2.66	8.83	10.94
Shanghai Composite	3 715	2.58	5.66	6.98
VIX - Implied Volatility Index	18.98	15.66	22.85	-16.57

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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