FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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Short sellers capitulate

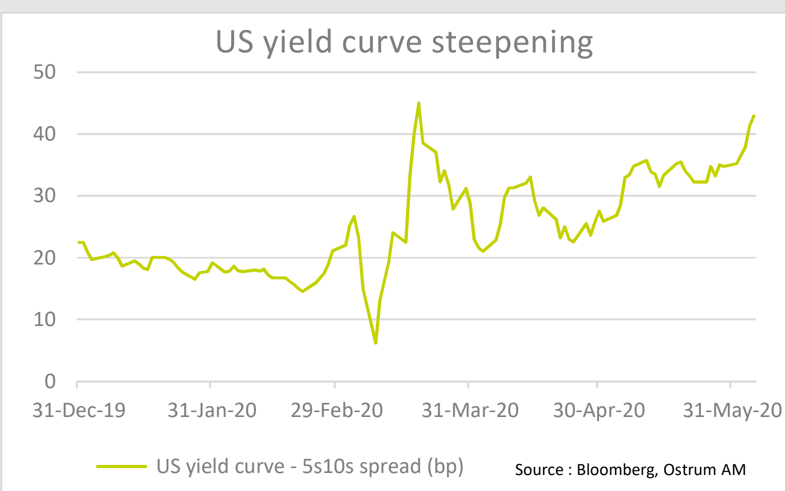
Key Points

- **European equity markets post double-digit returns last week**
- **ECB adds 600mds € to PEPP**
- **Fed may opt for yield curve control**
- **Considerable tightening in spreads**

Equity short sellers seem to have capitulated. The S&P 500 index hovers about the 3200 mark amid short covering. Sentiment vis-à-vis European stock markets has considerably improved since the EU recovery plan proposal. The main European indices made gains in the vicinity of 10% last week. Cyclical value stocks and banks are being bought. This time round, bond yields have indeed risen sharply in response to the risk asset rally. The 10-year yield on Treasuries is now trading above 0.90%. A new round of ECB easing (600b increase in PEPP) slowed the rise in Bun yields and sparked a sharp narrowing in sovereign spreads. At $1.13, the euro's rise emphasizes investor confidence in the euro area. The dollar remains weak ahead of the FOMC decision. A yield curve policy may be debated this week.

Credit markets remain well oriented, buoyed by strong final demand and increased central bank support. Credit spreads narrowed by more than 20bp last week and more significantly in speculative-grade markets. Emerging debt denominated in US dollars also rallied with spreads well within 500bp vs. Treasuries.

Chart of the week



The FOMC will meet this week. A yield curve control may be debated this week.

This policy consists in targeting long-term rates in an attempt to anchor market expectations and ensure low-cost funding of deficits. Under this monetary regime, rate volatility will likely fall thanks to the conditional support of Central Banks.

The sharp widening in 5s10s spreads may indicate that markets expect the Fed policymakers to target 5-year bond yields.

Short sellers capitulate

Is irrational exuberance reemerging in financial markets? Dollar depreciation is funding positions in risk assets including equities, energy commodities, credit or even CLO tranches. The 2009 carry trade may be repeating itself. Unprecedented liquidity provisioning by the Central Banks remains the main driver of the violent rise in risky asset prices since their low point in March. Excess asset demand induced by monetary easing is catching off guard the bearish consensus, which had built up as activity plunged. The speculative net short positioning in stocks on S&P futures diminished last week from extreme levels. Hence, pessimistic investors are capitulating. The unwinding of positions has sparked large swings in asset prices with no relation to underlying fundamentals. Yet, the latest economic releases suggest that April was indeed the low point in the cycle. Service activity has improved in China (55). Most European surveys have initiated a rebound linked to the gradual easing of lockdown measures in several countries. In the US, the employment situation turned out to be better than expected in May although the gap between the ADP estimate (2.7mn jobs lost in May) and the BLS non-farm payroll data of 3mn private jobs added, reflecting a sharp reduction in temporary unemployment.

The ECB expands PEPP, the Fed may opt for yield curve control

The ECB raised the amount of asset purchases adding €600b to the PEPP scheme started in March. The asset purchase program now totaling €1.35T will run until June 2021. Reinvestments of PEPP bond proceeds are expected until the end of 2022. Excess liquidity will also increase after the new TLTRO-III. The transaction may add €800b to the financial system. On this note, the ECB did not alter the tiering system of bank reserves which exonerates banks from the negative deposit rates despite increased excess liquidity. Adjustment at a later date remains likely.

Markets will pay attention to the Fed meeting which may opt for long-run Treasury yield targeting. The policy will aim at preventing a disorderly yield increase. The targeted yield may be a 5- or 10-year rate. The objective is also limit balance sheet growth at a time when Fed total assets surpass $7T.

Constructive sentiment on euro area

In terms of strategy, the sharp rise in equity markets was fueled by short covering. The capitulation of pessimistic investors resulted in a 10% weekly on the French CAC 40 for instance. Investor sentiment towards European equities has greatly improved so that non-resident accounts are again accumulating holdings in euro area stocks. The euro exchange rate is up to 1.13$. The other new element pertains to asset allocation flows. Until recently, rising equity markets has not weighed on bond yields. Bond funds are now experiencing outflows which fund inflows into risky assets. In the US, Treasury bond ETFs recorded their first week of outflows last week since the outbreak of the crisis.

In fixed income markets, bund yields notably rose in the wake of the US Treasury market. The yield on German benchmark bond hit -0.28%. The recovery fund proposed by the European Commission, which remains to be validated, will require large issuance of EU bonds which will compete with Bunds. This may have added upward pressure on German bond yields. The ECB's decision to ease policy still helped bunds outperform US 10-year notes (+12bp vs. +26bp). Besides employment numbers, the market may be testing the Fed's commitment to keep yields low even as negative Fed Funds rates appear off the table. The Fed will take no chance on market volatility. This situation argues for a long stance on US Treasuries as 10-year note yields hover about 0.90%. Curve steepening continues, and 30-year yields may increase further. Gilts performed in line with Bunds. It is worth keeping in mind that the BoE does not rule out negative rates. In Japan, whilst 10-year yields oscillate about 0%, the 10s30s spread has room to widen out in keeping with the US backend.

Sovereign spreads have continued to narrow after the European Commission launched its proposal for a recovery fund. The spread on Italy is now around 170bp on 10-year maturities. The syndication of 2030 BTP drew investor demand in excess of a €100b. Positioning surveys point to significant final investor over-exposure to peripheral sovereign bond markets. In turn Portugal and Spain bonds are trading within 90bp.

Credit markets are benefitting from the risk-on environment. Spreads on investment grade corporate bonds narrowed by 36bp (spreads vs. Bunds) with financials outperforming slightly. In the US, the average IG spread has now shrunk to 146bp from over 375bp at the height of the financial stress. The rally in spreads accelerated in the past two weeks as the Fed started credit bond purchases as announced back in March. The high yield market also performed very well. Yield premiums have adjusted lower, including in synthetic markets. The iTraxx Crossover index is now trading within 350bp. Lastly emerging bonds participates to the broad-based rally in risky assets. The depreciation in US dollar does facilitate the implementation in carry strategies on external debt and emerging market fund inflows have indeed picked up of late.

Main Market Indicators

G4 Government Bonds	08-Jun-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.62 %	+4	+16	-1
EUR Bunds 10y	-0.32%	+9	+22	-13
EUR Bunds 2s10s	30 bp	+5	+6	-12
USD Treasuries 2y	0.21 %	+6	+6	-136
USD Treasuries 10y	0.87 %	+21	+19	-105
USD Treasuries 2s10s	66 bp	+16	+13	+31
GBP Gilt 10y	0.33 %	+10	+10	-49
JPY JGB 10y	0.05 %	+4	+5	+6
€ Sovereign Spreads (10y)	**08-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	37 bp	-1	-13	+7
Italy	172 bp	-17	-67	+12
Spain	87 bp	-11	-47	+21
Inflation Break-evens (10y)	**08-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	51 bp	+9	+21	-
USD TIPS	126 bp	+7	+14	-53
GBP Gilt Index-Linked	293 bp	-1	+12	-18
EUR Credit Indices	**08-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	132 bp	-36	-58	+39
EUR Agencies OAS	51 bp	-9	-23	+7
EUR Securitized - Covered OAS	41 bp	-7	-27	0
EUR Pan-European High Yield OAS	496 bp	-79	-180	+192
EUR/USD CDS Indices 5y	**08-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	60 bp	-10	-24	+16
iTraxx Crossover	338 bp	-77	-174	+131
CDX IG	66 bp	-12	-25	+21
CDX High Yield	438 bp	-80	-199	+158
Emerging Markets	**08-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	460 bp	-55	-135	+170
Currencies	**08-Jun-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.129	+1.46	+4.19	+0.57
GBP/USD	$1.268	+1.76	+2.21	-4.37
USD/JPY	¥108.61	-0.95	-1.8	-0.03
Commodity Futures	**08-Jun-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$41.0	$2.7	$8.9	-$22.0
Gold	$1 691.8	-$47.1	-$10.9	$169.0
Equity Market Indices	**08-Jun-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 208	5.09	9.61	-0.60
EuroStoxx 50	3 366	9.48	15.87	-10.02
CAC 40	5 183	8.83	13.93	-13.30
Nikkei 225	23 178	5.06	14.86	-2.02
Shanghai Composite	2 938	0.77	1.47	-3.68
VIX - Implied Volatility Index	25.11	-11.23	-10.44	81.86

Source: Bloomberg, Ostrum Asset Management

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