MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

N° 125 // **September 11, 2023**

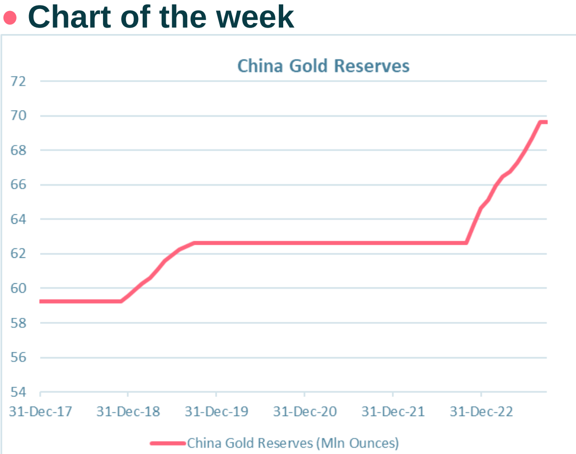
Topic of the week: BRICS+: to protect against the dollar.

- **U.S. geopolitical tensions and financial sanctions have accelerated cross-border transactions in local currencies;**
- **The use of the yuan in China's cross-border transactions is accelerating;**
- **The objective of the BRICS+ is also the de-dollarization of the energy market;**
- **Digitalization is an important leverage;**
- **The risk of fragmentation of the global payment system could also contribute to a fragmentation of the global trade.**

Market review: The US dollar reigns

- **The greenback appreciates against all currencies;**
- **T-note yields within 4.20-4.30% range;**
- **Heavy bond issuance weighs on sovereign and credit markets;**
- **European stocks down 1-2% last week.**

Chart of the week



Source: Bloomberg, Ostrum AM

China continues to accumulate foreign exchange reserves with its trade surpluses, but their composition is changing.

In response to the weakness of the yuan, the monetary authorities sold Treasuries (for around $200 billion since 2021) but the total reserves remained unchanged.

As a substitute for holdings in Treasuries, China is notably accumulating gold for a total now close to 70 mln ounces. At the current price, reserves of the preciosu metal are valued at $133 billion. It is likely that Russia sold China part of this gold.

Figure of the week

32

Source : DIHK

32% of German companies plan to relocate their production abroad or reduce it in Germany due to rising energy costs. This is to be compared to 16% last year.

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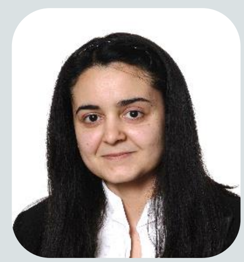

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Topic of the week

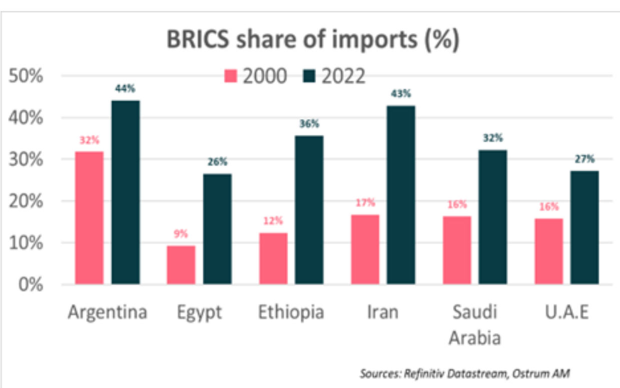
BRICS+: to protect against the dollar

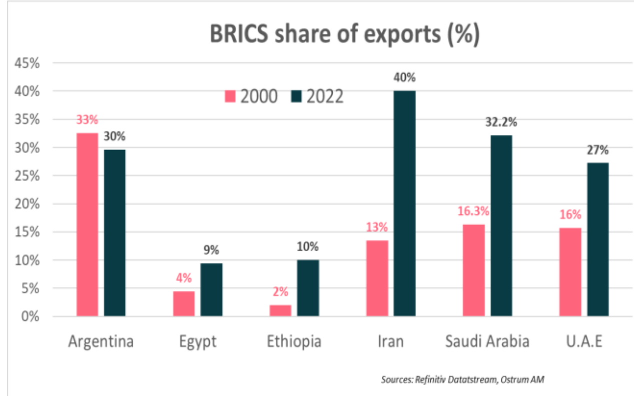
On 28 August, the BRICS summit in Johannesburg announced its expansion to 6 new members in 2024: Iran, Saudi Arabia, the United Arab Emirates, Ethiopia, Egypt, and Argentina. This expansion was a major challenge for the BRICS that were very different economically, politically, and diplomatically. The aim of this summit is to accelerate cross-border transactions in local currencies to reduce their vulnerability on the dollar.

The goal: Accelerate cross-border transactions in local currencies

The BRICS+ agreed to accelerate cross-border transactions in local currencies. Indeed, the US financial sanctions against Russia, the freezing of its 300 billion dollars of assets in foreign currencies and its exclusion from the SWIFT payment system, made many emerging countries aware that they could in the future also be impacted by the same sanctions. This is also the main reason why the attractiveness to join the group is strong. More than 40 countries have expressed interest in joining the BRICS.

The share of the BRICS in world exports is almost 25%. The charts below show the share of the BRICS in imports and exports of the 6 new members.

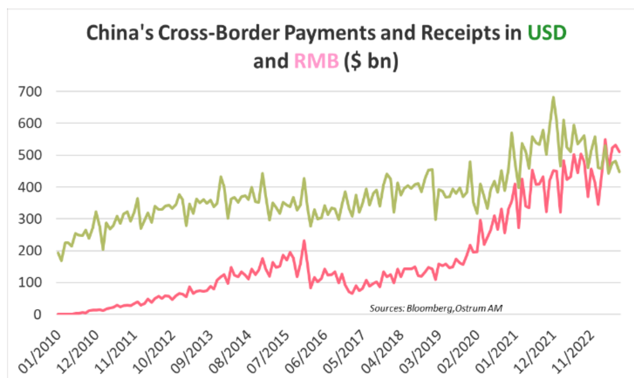




Between 2000 and 2022, the share of imports from the BRICS increased significantly for the 6 new members, almost doubling for oil and gas countries. The BRICS share of exports is highest in Iran, reflecting the circumvention of international financial sanctions. Given the intensification of trade between the BRICS+, it seems logical to favor transactions in local currencies.

The use of the yuan accelerates

China's cross-border transactions in yuan have exceeded for the first time those in dollar, as shown in the chart below, to reach $ 510 billion , or half of its transactions!

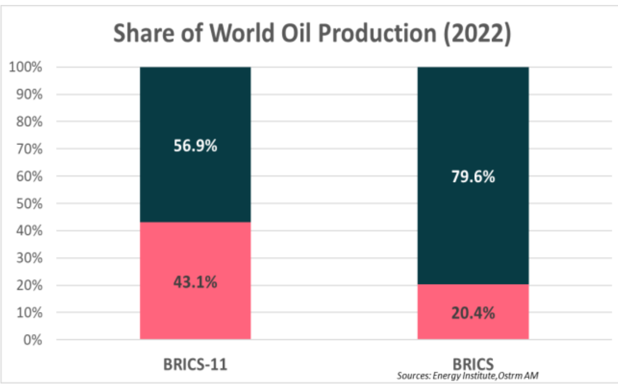


This was facilitated by the extensive foreign exchange swap line network that PBoC had set up in 2008, worth $480 billion and signed by 41 countries. These swap lines have also served as cross-border rescue loans to countries in financial distress of the Belt and Road Initiative. $42 billion of foreign exchange swap line was activated in 2021 for these countries. At the end of March 2023, $15.6 billion of swap lines were activated, a record, reflecting the willingness of emerging countries to reduce their dependence on the dollar.

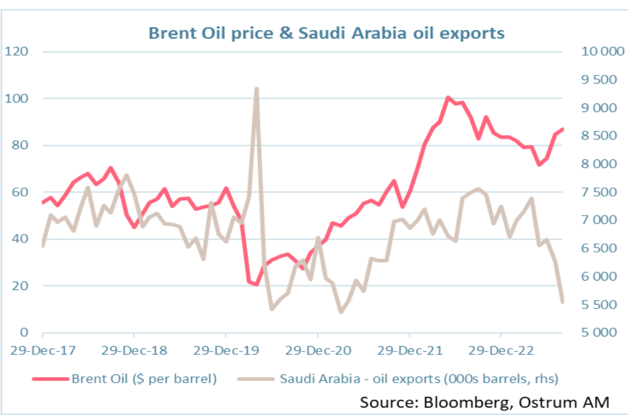
On the other hand, the use of the yuan is not limited to bilateral transactions with China. India pays its Russian oil deliveries in yuan. Argentina has repaid part of its debt to the IMF in yuan. Argentina probably used its swap line with China as part of a cross-border rescue loan.

De-Dollarization of Energy Market

The entry of Saudi Arabia is an important turning point for the BRICS. Now, the BRICS+ represents 43% of the global rough supply, double that of the BRICS, as shown in the chart below.



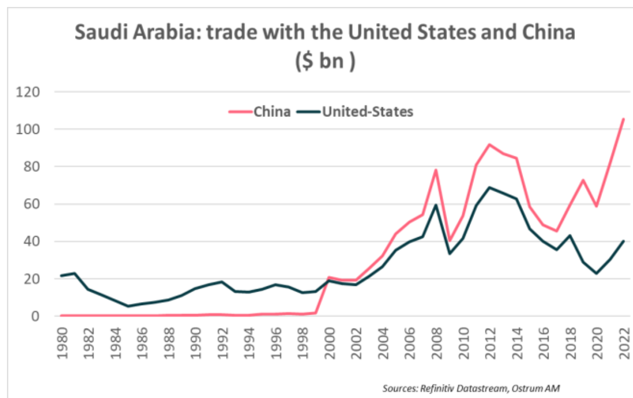
This will inevitably impact the balance of the oil market. The consequences are already immediate as shown in the chart below showing Saudi oil exports and Brent price.



The price of Brent has rebounded for the first time at $90 per barrel since November 2022. Saudi oil exports reached a two-year low of 5,500 thousand barrels, reflecting the voluntary production cuts. On the other hand, Russia and Saudi Arabia said they would continue to reduce production by 1.7 million bpd until the end of 2023. The Kingdom also reported reducing its crude oil exports by 300,000 bpd until the end of the year. Aramco also announced the sale of $ 50 billion shares, which will translate into higher crude prices. Saudi Arabia must finance major investment projects under its Saudi Vision 2030 plan and therefore needs significant oil revenues.

This creates economic fragmentation at global level, especially for countries whose energy supply depends on external sources such as the Eurozone. C.Lagarde's speech in Jackson Hole clearly evoked this point highlighting the high energy vulnerability of the Eurozone but also the critical materials necessary for the green transition. This economic fragmentation threatens the price and macroeconomic stability of countries dependent on the rest of the world for their supplies. This is a point on which we must be vigilant.

The other objective behind Saudi Arabia's entry is the de-dollarization of the energy market. The strength of the dollar is based on petrodollars. Since the 1980s, payments for OPEC oil deliveries were settled exclusively in dollars in exchange for US military protection. This explains the peg of the riyal to the dollar since that date. The chart below shows that trade between Saudi Arabia and China (more than $100 bn) has surpassed that with the United States.



The acceleration occurred in 2022, the year of the Russian invasion of Ukraine. The United States is no longer dependent on the Kingdom thanks to the development of its shale industry. The financial sanctions against Russia have made Saudi Arabia aware that it could also be targeted by such sanctions in the future and should therefore diversify its foreign exchange payments. For now, the UAE has become the first OPEC country to include the Indian rupee payment for oil and gas. For Saudi Arabia, abruptly emancipating from the dollar have a cost and risks putting its peg under pressure threatening its macroeconomic and financial stability. This will be a topic for the coming years or months…

Digitalization as an important leverage

Expansion to 11 will make it possible to institutionalize this aim. Digitalisation should speed up cross-border transactions in local currencies.

Institutions to manage cross-border BRICS transactions already exist. The BRICS Interbank Cooperation Mechanism (BRICM) was created on 15 April 2010 to facilitate cross-border payments between member countries. Its members are Brazilian Development Bank (BNDES), State Corporation "Bank for Development and Foreign Economic Affairs (Vnesheconombank)" (Russia), Export-Import Bank of India (Exim), China Development Bank Corporation, Development Bank of Southern Africa (DBSA).

BRICS Pay, the digital platform created in 2018, aims to enable digital payments between different BRICS+ countries. An app like Apple Pay is also under consideration to enable purchases in any of the 11 BRICS+ countries, regardless of the currency in which the payment and money on the buyer's account are denominated.

The ASEAN countries have also indicated that they want to accelerate their financial integration by integrating their QR code payment system. Thus, Indonesia, Malaysia, the Philippines, Singapore, and Thailand will integrate their payment system by QR code. This remains limited to market transactions, to reduce transaction costs for Asian tourists. 3 million Malaysians visited Indonesia in 2019, and a QR code system that allows them to pay in their own currency at a good exchange rate is an incentive to visit more often and spend more money.

A risk of fragmentation of the global payment system

The BRICS acceleration of cross-border transactions in local currencies does not pose an immediate threat to the US dollar. Although it has lost some of its luster since 2015, the dollar accounts for 85% of foreign exchange transactions, 59% of central bank foreign exchange reserves, and 45% of commercial transactions on the SWIFT payment system.

However, the rise of local currency transactions risks creating fragmentation in the global payment system with identifiable costs. CIPS, the cross-border payment system, used for clearing and settling cross-border transactions in yuan, also offers a payment messaging standard. In September 2023, CIPS registered a total of 1456 participants worldwide, including 91 permanent participants. Nevertheless, CIPS remains to a large extent linked to the SWIFT messaging system to make a significant share of its payments.

A fragmented payment system could induce trade biases against other blocs, which could call into question the current functioning of international trade and investment flows on geopolitical considerations, contributing to the fragmentation of world trade.

Zouhoure Bousbih

Market review

The US dollar reigns

The dollar is unrivaled as economic weakness takes hold in Europe and capital outflows from China weigh on the yuan. Stocks are down amid pressure on rates.

A broad-based rise in the US dollar is often associated with risk aversion in the financial markets. However, despite last week's modest decline in stocks, the current rebound in the greenback seems more linked to the economic downturn in the euro area and capital outflows from China which are fueling the weakness of the yuan. The CNH, yuan traded in Hong Kong, depreciated past 7.36 against the dollar. Bond markets remain volatile ahead of the all-important meetings of the Central Banks. The 10-Yr T-note yield fluctuates between 4.20% and 4.30%. The Bund is struggling to sustainably cross the 2.60% threshold. However, the heavy issuance schedule on the sovereign (France, Spain, agencies) and credit markets is putting some pressure on long-term maturity bonds. Credit spreads nevertheless narrowed slightly over the week against Bunds thanks to the improvement in swap spreads.

In the United States, the Beige book reports modest growth over the past six weeks. The job market is moderating as are price tensions according to anecdotes collected by the Federal Reserve. However, hourly productivity rose at a annualized rate of 3.5% in the second quarter, which helps to curb the rise in unit labor costs. In an economy dominated by services, the cost of labor is essential to determine domestic inflation. The ISM service index shows an improvement in activity but also a resurgence of tensions on input prices. New orders seem to validate growth of around 3% in the 3rd quarter. The trade deficit improved in July thanks to the automobile sector. Manufacturers have undoubtedly sought to relocate production in anticipation of the current labor conflict. The risk of a strike hangs over the sector if wage conditions are not significantly increased. The UAW union is asking for a 46% increase by 2027 with a reduction to 32 hours of weekly hours worked. In parallel, an agreement has been reached with the dockers' unions in the Pacific. These two examples bear witness to the persistent tensions in the labor market.

In the euro area, the surveys unanimously point to a decline, including in the service sector. The services PMI in the euro area plunged to 47.9 in August. In addition, 2nd quarter growth was trimmed to 0.1%. Household consumption (0%) is not yet benefiting from the rise in employment and early signs of disinflation. Inflation fears remain high (2.4% over the next three years in July according to the ECB survey) due in part to the recent rise in gasoline prices. In China, the economic calendar is getting lighter month after month. The latest surveys point to an improvement in the manufacturing sector. Inflation is still zero (0.1% in August).

US dollar strength against all currencies is inescapable and undoubtedly paradoxical in light of the current objectives of the enlargement of the BRICS. Capital outflows in China weigh on the yuan. The yen reflects the contradictions of the BoJ, which wants at all costs to avoid a sharp upshot in the Japanese 10-year yield. The 10-Yr JGB yield is stuck at 0.65%. A bond crash in Japan would have global repercussions. A sudden rise in the yen would follow and capital repatriation from Japanese institutions would hurt the euro and US markets. The T-note yield is ranging between 4.20% and 4.30%. The refinancing of the Treasury debt entails large bond issuance in the marketplace whilst foreign demand for UST has diminished. In the euro area, the Bund remains supported by the poor economic surveys. The heavy primary market issuance causes tensions. There was indeed a poor auction of long-term bonds in Austria and even long-term French OATs have had dome more difficulty to lure buyers. This caused temporary tension on the 10s30s spread (12 bp). The OLO market benefits from the Belgian Treasury's decision to tap household savings (€22 billion issued at 1-year maturity). There are indeed attractive opportunities on monetary instruments compared to short bank bonds, for example. The situation is mixed in the agency debt market. The Council of Europe was unable to issue the targeted amount, but the EIB issue met with more interest. Swap spreads widened again under the effect of hedging flows for these issues.

The credit market is also suffering from heavy issuance. Credit slightly underperforms swaps. A few high credit quality issuers were well placed but spreads were then able to widen on the secondary market. The market seems attentive to the destination of funds, particularly in the event of a risky acquisition. Furthermore, the CDS market seems disconnected from the underlying corporate bond market. The iTraxx IG is processed at around 70 bp.

The European high yield market seems resilient and outperformed the iTraxx XO over the past week. The spread compression trend has further intensified even as the premium on B vs. BB is close to all-time lows at 170 bps. The single-B class no longer looks attractive at current levels. Hybrids are underperforming, as are Tier 1 bonds held back by some activity in primary markets and one bank's decision not to call its Tier 1 bond. This asset class should nevertheless continue to recover. Flows to high yield remain negative for the seventh week in a row. Equity markets are also experiencing outflows. High oil prices, pressure on rates and lower projections for earnings towards the end of the year (in consumption) sparked losses in European stock markets (down 1 to 2%). A tax risk weighs on French banks.

Axel Botte

Main market indicators

G4 Government Bonds	11-Sep-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.08%	+6	+4	+32
EUR Bunds 10y	2.63%	+5	+1	+6
EUR Bunds 2s10s	-45.6bp	-1	-4	-25
USD Treasuries 2y	4.98%	+11	+9	+56
USD Treasuries 10y	4.29%	+11	+14	+41
USD Treasuries 2s10s	-69.8bp	+1	+5	-14
GBP Gilt 10y	4.47%	+1	-6	+80
JPY JGB 10y	0.71%	+7	+1	-18
€ Sovereign Spreads (10y)	**11-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	54bp	+2	+2	-1
Italy	175bp	+4	+10	-38
Spain	105bp	+1	+3	-4
Inflation Break-evens (10y)	**11-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.64%	+6	+0	+9
USD 10y Inflation Swap	2.63%	+8	-1	+11
GBP 10y Inflation Swap	3.99%	+3	+10	+8
EUR Credit Indices	**11-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	155bp	-1	+4	-12
EUR Agencies OAS	74bp	+0	-2	-5
EUR Securitized - Covered OAS	82bp	-2	-7	-2
EUR Pan-European High Yield OAS	448bp	-8	-7	-64
EUR/USD CDS Indices 5y	**11-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	70bp	+1	-1	-20
iTraxx Crossover	395bp	+4	-5	-79
CDX IG	64bp	+0	-3	-18
CDX High Yield	427bp	+3	-6	-57
Emerging Markets	**11-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	420bp	+2	+9	-33
Currencies	**11-Sep-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.072	-0.704	-2.092	0.1
GBP/USD	$1.252	-0.855	-1.410	3.6
USD/JPY	JPY 147	-0.041	-1.072	-10.5
Commodity Futures	**11-Sep-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$90.5	$1.5	$4.3	10.2
Gold	$1 925.6	-$17.1	$11.9	5.6
Equity Market Indices	**11-Sep-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 457	-1.11	-0.15	16.1
EuroStoxx 50	4 247	-0.77	-1.72	12.0
CAC 40	7 273	-0.09	-0.92	12.3
Nikkei 225	32 468	-1.43	-0.02	24.4
Shanghai Composite	3 143	-1.08	-1.46	1.7
VIX - Implied Volatility Index	14.19	8.40	-4.38	-34.5

Source: Bloomberg, Ostrum AM

Additional notes

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