MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 069 // **May 9, 2022**

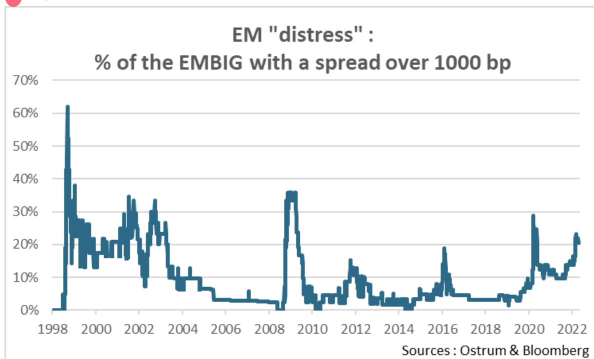
Topic of the week: Banking Union: as important as it is abstruse

- **Banking Union may seem like a detail or an abstract subject. It is in fact a fundamental element of the European construction, it was a major step in the resolution of the sovereign crisis of the last decade and it is the most important device to ensure the stability of the financial system;**
- **The holding of domestic securities remains important and raises old fears about a vicious bank/sovereign circle;**
- **But the main missing link is the European Deposit Insurance System (EEAS). Progress now seems more likely.**

Market review: Post-FOMC pullback

- **Fed: 50 bp hike and QT to start in June;**
- **High real yields bite;**
- **Equities nosedive after Fed decision;**
- **Greenback is still the only safe haven.**

Chart of the week



We call a "distressed" country, one that has a spread of 1000 bp or more. Following this definition, we find that more than 20% of the countries in the EMBIG index have passed that threashold.

This is an unusually high proportion. If we except the brief covid-related blip in early 2020, we have to go back to the great recession of 2009 or to the very beginning of the century to find similar levels.

This shows that, at least for a significant proporion of the emerging countries, the level of stress is rapidly mounting.

Figure of the week

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Source : Ostrum AM

The monthly increase of consumer credit has been $52 Bn in the US. This is three times the norm. An illustration that households are increasingly struggling with the jump in inflation.

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● **Topic of the week**

Banking Union: as important as it is abstruse

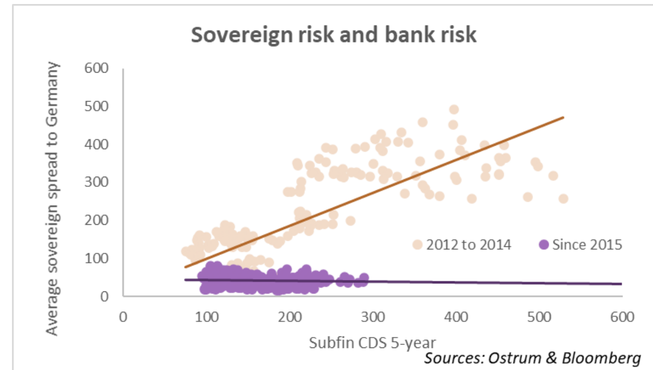
The Banking Union may seem a detail or an abstract subject. It is in fact a fundamental element of the European construction: it was a major step in the resolution of the sovereign crisis of the last decade and it is the most important device to ensure the stability of the European financial system. We could therefore not emphasize too much its importance. As often with Europe, progress has been incomplete. The main missing warehouse is the European deposit insurance scheme (EDIS). Progress now seems more plausible.

Why this is fundamental

The Banking Union was established in 2014 following the sovereign crisis. It consists essentially of a banking supervision system, the SSM (Single Supervisory Mechanism), and the SRM (Single Resolution Mechanism) which deals with bank defaults. While this progress may seem like an abstract and peripheral subject, it is in fact considered to be the greatest European economic convergence policy since the introduction of the euro and a fundamental complement to it.

Banking union (BU) is probably the most important step in terms of European integration since the launch of the euro. The most visible part of the financial crisis was, at least initially, the problem facing the sovereign. Assistance programs were launched in Greece and Ireland in 2010, then in Portugal in 2011 and finally in Cyprus in 2013. However, it quickly became apparent that the weakness of the financial system was an equally important problem. The feed-back loop has been identified and discussed as early as during the June 2012 European Summit, and a political will to address the issue has emerged.

This was a major step towards resolving the sovereign crisis of the last decade. By raising banking supervision to the supranational level and by limiting the implicit guarantee of the States over their banks, this helped to break in part the vicious circle between sovereign risk and banking risk (see next chapter for a detailed discussion of the topic). The quite spectacular chart below shows that these two risks have effectively decoupled beyond 2014.



On the other hand, this opened the door to the ECB's QE, which happened in the months following the introduction of the BU.

However, the mechanism is incomplete. The next chapter recalls and describes the problem of the vicious circle that existed between financial institutions and the State. The next chapter shows that one of the fundamental problems was that some banks were too exposed to the obligations of their own government. Finally, when the UB was launched, negotiations on a common deposit protection system had not been successful. This is the main missing link and progress is now (eventually!) possible.

The sovereign/bank vicious circle

One of the characteristics of the sovereign crisis at the beginning of the last decade was the emergence of the vicious circle between sovereign and banks. The deterioration of the sovereign's signature quality affected that of domestic financial institutions and vice versa.

The mechanism of the financial crisis and the sovereign/bank vicious circle has been widely discussed in the literature. Angelini, Grande and Panetta (2014) provide a comprehensive description of the mechanism by which banking and sovereign risk were linked. The deterioration of a financial institution has an impact on the sovereign because the market has assumed that there is an implicit guarantee, and that taxpayers would be involved. From this perspective, the financial system was de facto considered an off-balance sheet liability for governments. This implicit guarantee is difficult to measure, but it is clear that it is taken into account by the market when banks borrow.

At the same time, a deterioration of the sovereign has an impact on banks on both sides of their balance sheets. As much of the banks' balance sheet was invested in domestic

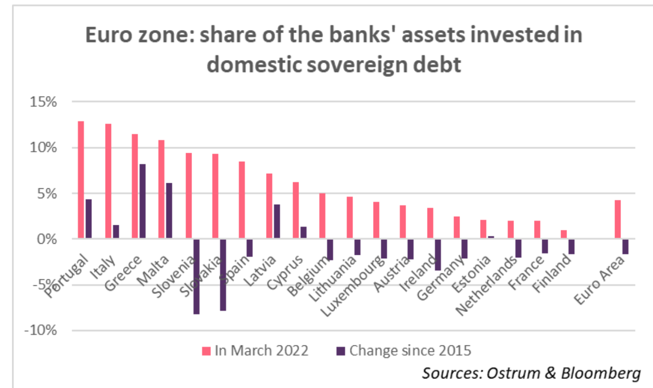
bonds, the spread of sovereign spreads had an impact on the valuations of their portfolio. In a way, this is no different from a bank's exposure as a creditor, but the domestic bias (the fact that a large portion of the bond portfolio is invested in bonds in the same country) makes the sensitivity much higher. With respect to liabilities, the cost of financing was evolving in parallel with the sovereign increase. This is because the liabilities on the balance sheet are valued against the domestic sovereign curve, so that a widening of the spread for a country was reflected in the cost of financing for the banks in that same country. The role of rating agencies should also be emphasized, with ratings downgrades of a sovereign generally reflected in that of the country's banks. Finally, the stress created in the market has made liquidity disappear once again, making it difficult for banks to borrow.

Beyond these direct bank/sovereign effects there are also indirect effects that pass through economic activity. The deterioration in the solvency of banks and sovereign countries has had a negative impact on the economy. In the case of the sovereign, the need for fiscal consolidation has dampened growth, while in the case of banks, the difficulty of financing has been reflected in the tightening of their credit standards. In turn, the weakness of the economy has also had a feedback effect, in the form of lower tax revenues for the government and in the form of lower credit quality and strong debt for the banks.

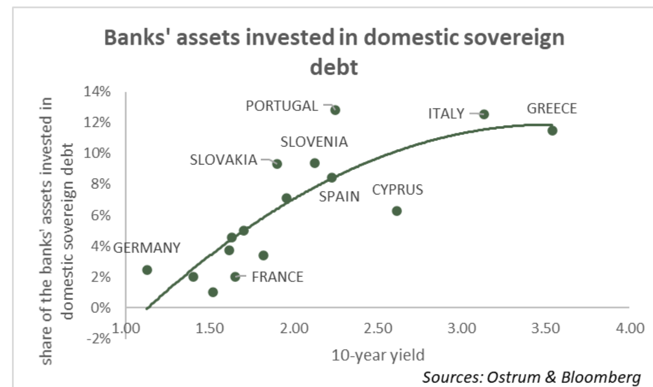
An exposure that remains of concern

We have to start with the good news. Banks' exposure to their domestic sovereign rose significantly during the sovereign crisis from 2010 to 2014. On the other hand, the trend has clearly reversed since then, the ECB's QE, in particular, has enabled states to find a new buyer and banks to offload.
The level of exposure is therefore much less of a concern than it was in 2015.

The details by country are much less encouraging. On the one hand, as the chart below shows, the dispersion of debt holdings by country is very strong. Some countries have levels well above 10% of their assets (Portugal, Italy, Greece and Malta).
On the other hand it seems that a number of countries have increased their detention since 2015, some significantly.



The reason for this is simple. The sovereign/bank vicious circle has not completely disappeared. In particular the valuation of the debts of the banks is always largely done in relation to their sovereign. The cost of financing a bank therefore depends, in part, on the cost of financing the sovereign. It is therefore logical that banks in high-interest countries should be required to carry assets with similar profitability. And so to buy domestic sovereign debt. The chart below illustrates this dilemma well.



This, in the current context of rapidly rising rates; this situation brings back old fears and old demons.

The missing link: the deposit guarantee

An important BU brick is still missing, the European deposit insurance scheme (EDIS). A European deposit insurance system is likely to have a positive effect on the situation of

Member States and banks, since it can better help to absorb local shocks. This can discourage speculation against certain countries or banks, and thus reduce the risk of bank panic. It would therefore be one more stone brought to European financial stability.

Talks about sharing the responsibility of deposits across the EU of 27, or only the 19 countries sharing the euro, dragged on for years because the idea did not seem acceptable to several Northern European countries, led by Germany. The fear was to create a system that would serve, de facto, to pay non-performing claims in the countries most affected by the sovereign crisis of the last decade, namely the southern countries and Ireland. In this case it would be a simple disguised transfer from the countries in the north to those in the south.

The impressive effort that has been made to reduce bad loans in these banks and the more stringent prudential ratios make this fear much less present. In return the weakness of some banks in the north, in particular the Landesbank or Sparkasse may also have played a role since it is no longer at all incongruous to think that Germany could be at risk and therefore benefit from a common European insurance.

The Commission will also propose a law on the use of liquidity in large cross-border banking groups. This will also be a major step in opening up the possibility of large-scale cross-border bank mergers. This is probably one of the best ways to combat the geographical fragmentation of the European system.

The finance ministers meeting last week hope that all of this package will go through the EU legislative process by mid-2024 and will enter into force in early 2025, although this may take longer.

The proposal for a regulation provides for the establishment of a European deposit insurance scheme (EDIS) in three successive phases: a reinsurance mechanism over the first three years, a co-insurance mechanism for the next four years and a full cruise insurance mechanism. The Single Resolution Mechanism (SRM) of the Banking Union would have its responsibilities extended to the management of the EDIS. A Deposit Insurance Fund (DIF) would be gradually constituted by contributions calculated and invoiced by the participants and paid by the participating banks.

The Finance Committee of the Senate notes: “In the light of the principle of subsidiarity, the very principle of common arrangements for the protection of the deposits of credit institutions under the jurisdiction of the Banking Union perfectly justifies legislative action by the European Union. This is also a logical and necessary evolution of the Banking Union: in a system where the responsibilities of banking supervision and resolution are already shared, the situations in which a national deposit guarantee system can be used are no longer a matter of national jurisdiction.”

Conclusion

As is often the case with Europe, the progress made by the BU has been incomplete. Banks, especially in the most vulnerable countries where rates are high, still have a strong incentive to invest in their domestic debt. The vicious circle between the sovereign and the banks, although it has been greatly reduced, has not disappeared. The recent rebound in rates is bringing up old demons.

But the main missing link is the European Deposit Insurance System (EEAS). Progress now seems more likely. It seems that the planets are aligning themselves so that progress is finally being made on this front.

Stéphane Déo

Market review

Post-FOMC pull back

Knee-jerk rise post Fed brutally reversed with Nasdaq plunging again and the greenback as the only safe haven.

The previous FOMC, although punctuated by rate hikes, were followed by a sharp rebound in equities over the following weeks. Last Wednesday, the knee-jerk reaction (3% rise in equities, fall in rates and the dollar) to the announcement of a 50 bp hike and the gradual implementation of quantitative tightening has reversed suddenly the next day. This nosedive appears déjà-vu after the violent drop in the equity markets observed on Friday, April 29 (-3.6% on the S&P 500). Yields broke their recent peaks at 3.10% on the T-note or close to 1.15 % on Bunds as equity indices plunged back below their pre-FOMC levels. The dollar remains the only safe haven. The greenback is indeed at a 20-year high (DXY). The joint weakness of the euro, yen and yuan leaves no alternative. The backfire affects all risky assets. The hemorrhage continues on credit and high yield, fueling the demand for credit risk protection via derivatives despite attractive valuation levels. Italian sovereign spreads are approaching 200 bp. The central banks' hawkish turn is clearly reversing the reach for yield mantra that had compressed risk premia.

The Federal Reserve raised its Fed funds rate by 50 bp to 1% last Wednesday. Bringing down inflation (8.5% in April) is clearly the Fed's priority. Jerome Powell thus seemed to be addressing US households much more than market participants, who are struggling to grasp the magnitude of the monetary tightening to come. The tone of Powell's press conference was nevertheless less hawkish than the inter-meeting communication of FOMC participants. Jerome Powell appears to be ruling out 75 bp hikes favoring 50 bp steps in the next two or even three meetings. The rate hike is accompanied by a balance sheet reduction policy. Starting in June, the Fed will no longer reinvest all of its portfolio maturities. Between June and August, the redemption payments that will not be reinvested will be limited to $30 billion in Treasuries and $17.5 billion in MBS each month. From September, these amounts will double so that the balance sheet will decrease by $95 billion per month. Gradual quantitative tightening is justified by the size of the SOMA maturities until August (nearly $550 billion) and the prospect of a series of 50 bp rate hikes. Fed caution provides some support for long yields as do downwardly revised Treasury bond issuance. The quarterly refinancing shows negative net issues between April and June (-$26bn) or $92bn less than was expected in January thanks to a favorable cash position. Between July and September, the federal government will borrow $182 billion. Auction sizes have been cut across all coupon maturities but the next TIPS auctions will increase by $1bn to take advantage of the strong demand for inflation protection. Across the Atlantic, the Bank of England raised its rate by 25bp despite three out of nine votes in favor of a 50bp hike. Inflation will exceed 10% over the next few months and will eventually lead to a sharp slowdown or even a recession in 2023. Sterling plunged to $1.23 as market rate expectations were pared.

Volatility in the fixed income markets remains considerable. Intra-day yield changes are frequently greater than 10 bp. The trend on yields still shows significant asymmetry to the upside reflecting hawkish comments from central bankers ahead of the FOMC meeting. Monetary tightening is gradually raising the floor on interest rates with a clear overshooting of real bond yields. Breakeven inflation rates shrank as a result. A steepening of the yield curve is also taking shape as markets begin to price in quantitative tightening. The 2-10 year spread increased by 13 bp last week to 34 bp. The T-note yield acceleration to the upside towards the end of the week is fueled by new selling pressure from speculative accounts, which had reduced their short positions in future contracts at the end of April (with short covering estimated at around 200k contracts). Bund yields are also overreacting, now approaching 1.15%. The bond market is clearly testing the ECB's pain threshold. Central bankers are alluding to a rate hike in July, but market pressure could force the ECB to hike as early as June. Sovereign spreads are also under stress. Christine Lagarde regularly stresses the importance of ensuring the proper transmission of monetary policy, which the market interprets as the promise of open-market intervention to avoid undue asymmetrical increases in borrowing costs within the euro area. Such a policy tool already existed with the SMP in 2011 when Italy had practically lost access to the sovereign bond market after two rate hikes by the ECB. In this context, Italian 10-year BTPs widened to 200 bp. Italian bonds did overreact to market jitters compared to Iberian debt.

Credit spreads continued to widen with a further 5 bp increase last week. Competition from sovereign bond yields induces arbitrage away from credit by institutional investors. Hybrid debt suffers from high beta. The real estate sector is also penalized by rising long-term interest rates. High yield (397 bp against swap) is facing significant fund outflows. The iTraxx XO broke above the 450 bp threshold, even reaching a 474 bp wide.

Despite extreme market volatility, the US stock indices closed last week almost unchanged. However, nearly half of Nasdaq stocks are trading 50% below their previous highs. Stock market performance hence remains highly concentrated. In Europe, the weekly drop was a sizeable 4.5%. The risk of stagflation and weak sentiment are weighing on stock prices. Corporate earnings are up in aggregate and are being revised upwards thanks to sectors linked to commodities. Insurance erased some of its 2022 outperformance.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	09-May-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.25%	+0	+20	+87
EUR Bunds 10y	1.13%	+16	+42	+130
EUR Bunds 2s10s	87.5bp	+15	+22	+44
USD Treasuries 2y	2.64%	-9	+13	+191
USD Treasuries 10y	3.12%	+14	+42	+161
USD Treasuries 2s10s	47.8bp	+23	+30	-30
GBP Gilt 10y	1.99%	+8	+24	+102
JPY JGB 10y	0.25%	+2	+6	+4
€ Sovereign Spreads (10y)	09-May-22	1wk (bp)	1m (bp)	2022 (bp)
France	53.68bp	+1	+2	+16
Italy	205.04bp	+16	+21	+70
Spain	112.77bp	+8	+9	+38
Inflation Break-evens (10y)	09-May-22	1wk (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2.87%	-20	-9	+78
USD 10y Inflation Swap	3.12%	-3	+9	+34
GBP 10y Inflation Swap	4.47%	-21	-13	+30
EUR Credit Indices	09-May-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	161bp	+10	+30	+66
EUR Agencies OAS	67bp	+3	+2	+18
EUR Securitized - Covered OAS	79bp	+2	+7	+33
EUR Pan-European High Yield OAS	488bp	+38	+98	+170
EUR/USD CDS Indices 5y	09-May-22	1wk (bp)	1m (bp)	2022 (bp)
iTraxx IG	99bp	+9	+20	+51
iTraxx Crossover	474bp	+45	+99	+231
CDX IG	89bp	+4	+16	+39
CDX High Yield	492bp	+30	+81	+199
Emerging Markets	09-May-22	1wk (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	445bp	+5	+47	+76
Currencies	09-May-22	1wk (%)	1m (%)	2022 (%)
EUR/USD	$1.054	0.333	-3.142	-7.3
GBP/USD	$1.235	-1.145	-5.226	-8.7
USD/JPY	JPY 131	-0.444	-4.107	-12.0
Commodity Futures	09-May-22	-1wk ($)	-1m ($)	2022 (%)
Crude Brent	$110.6	$3.0	$8.4	45.83
Gold	$1 869.0	$5.9	-$84.6	2.17
Equity Market Indices	09-May-22	-1wk (%)	-1m (%)	2022 (%)
S&P 500	4 123	-0.21	-8.13	-13.5
EuroStoxx 50	3 568	-4.39	-7.51	-17.0
CAC 40	6 159	-4.15	-5.94	-13.9
Nikkei 225	26 319	-1.43	-2.47	-8.6
Shanghai Composite	3 004	1.55	-7.62	-17.5
VIX - Implied Volatility Index	33.12	2.41	56.52	92.3

Source: Bloomberg, Ostrum AM

Additional notes

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