MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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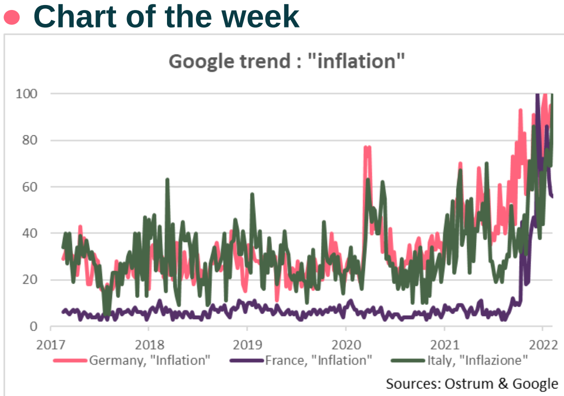
Topic of the week: Job market: a comparison between the US and Europe

- **The American and European labor markets are fundamentally different. A comparison between the two holds however surprises in store, the most extreme figures, compared to the historical, are not necessarily on the side of the Atlantic that we would think.**
- **All the ingredients for wage growth are there. A model on wages gives an increase that exceeds 4% of annual growth at the end of this year.**
- **In this case, after persistent inflation figures at a high level, there would be unmistakable signs of secondary effects. In this case, the ECB's tough guys, the "hawks", would have all the arguments for a monetary tightening.**

Market review: A suffocated market

- **High US inflation increases the pressure on the Fed;**
- **T-note yields briefly break above 2%;**
- **Peripheral debt spreads widen out;**
- **Corporate credit spreads increase.**

Chart of the week



Inflation expectations are both a fundamental concept of monetary policy and an extremely difficult element to measure. On the attached graph we look at an element, the «Google Trend», which lists searches for the word «inflation» in the three major countries of the Eurozone. The data is standardized, the week that has seen the most research of this term in 5 years is 100.

We can see very clearly that the subject has become much more prominent in recent months when it was marginal for years.

To the extent that these expectations also influence wage formation, this is an argument to be taken into account.

Figure of the week

7

Source : Ostrum AM

The European Systemic Risks Board has just published 5 warnings and 2 recommendations on the medium-term vulnerabilities of certain countries regarding the real estate market.

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Topic of the week

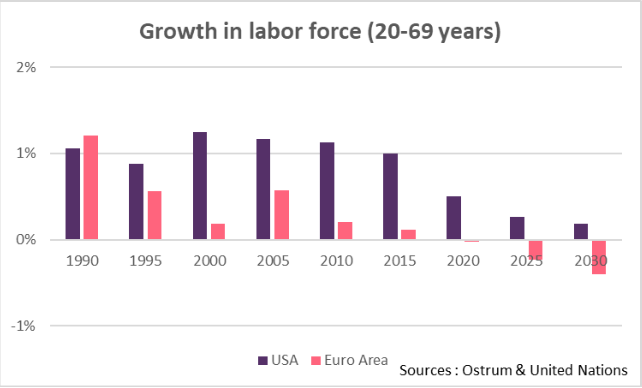
Job market: a comparison between the US and Europe

The American and European labour markets are fundamentally different. The level of the main variables, for example the unemployment rate, are also on very different levels. A comparison of the two holds however surprises in store, the most extreme figures, compared to the historical, are not necessarily on the side of the Atlantic that we would think. If the European labour market were to keep pace with the US labour market, particularly in terms of wages, the implications would be major for monetary policy, rates, business margins and other key market variables.

The labor markets in the United States and Europe are very different in particular, and not only in terms of flexibility. A subject that has been widely discussed by economists. This paper focuses on the cyclical aspect. It is clear that the American market is showing signs of overheating that are becoming increasingly evident. To quote just one figure, there are almost 11 million job vacancies for 6.5 million unemployed. That is 1.7 job offers per unemployed person, a level totally out of the norm. What about Europe? The difference is less obvious than it seems at first sight.

Demographic trends

Let's start with a long-term view. The level of population growth has dropped significantly on both sides of the Atlantic. In the United States, the working population grew by 1.1% per year over the decade 2000-2010, a figure that will rise to only 0.2% over the next ten years. This drop of 1.0 percentage points is almost the same as in Europe, where growth over the same period rose from +0.4% to -0.5%.

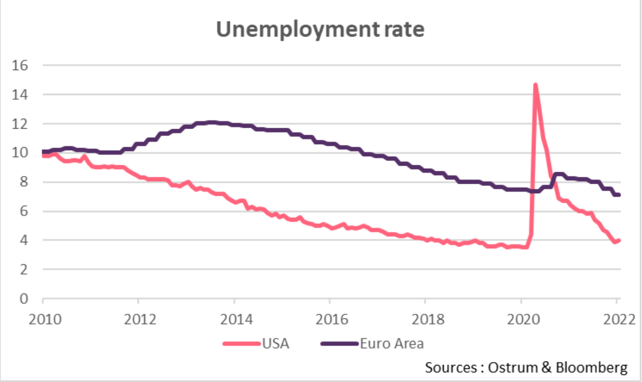


The deceleration is almost identical even though, of course, the starting point is different since the American population was more dynamic.

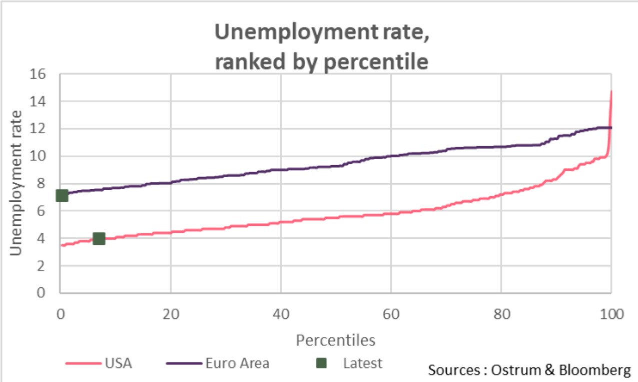
In both cases, however, this creates much less favorable conditions for the job supply .

Unemployment rate

The same is true. If the unemployment rate is different on both sides of the Atlantic, the dynamics are very similar. After the Covid crisis, the unemployment rate dropped very quickly and returned to near historic lows. The graph below illustrates this development.



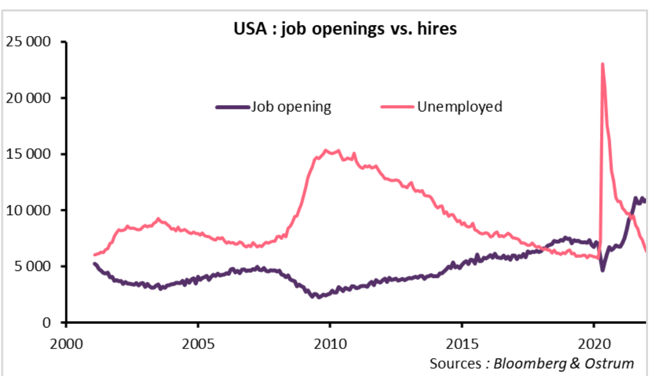
These data can be presented differently, with an "S-chart". We classify the unemployment rates observed since 1990 in percentiles. This gives the following graph.



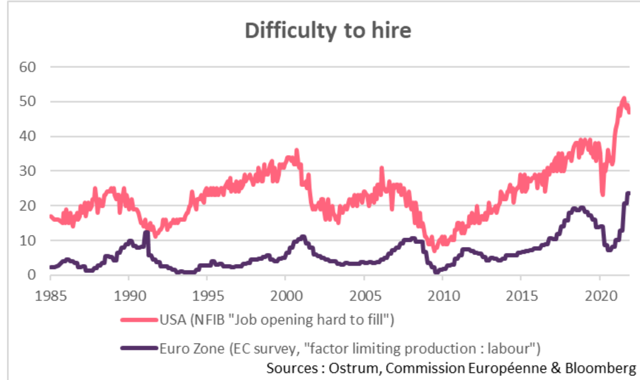
As with population growth, the message is twofold. On the one hand the United States does better than Europe, their unemployment rate tends to remain lower than in Europe. But from a cyclical point of view, the current level is, on both sides of the Atlantic, close to historic lows. In relative terms, Europe is even better than the United States: the January figure, an unemployment rate of 7.13% is the lowest ever recorded, while the unemployment rate of the United States at 4.0% is “only” in the 7th percentile.

Shortages?

Tensions in the US labor market are well known. The most impressive illustration, which we quoted in the introduction, is the divergence between job vacancies, at an unprecedented level, and the number of unemployed people, which is very low.

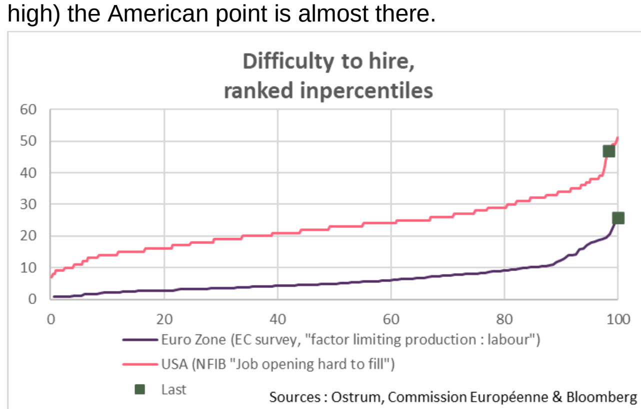


To have an element of comparison with Europe, we use the surveys. In the case of the United States, the NFIB, a survey of small businesses is used, where about half of respondents talk about difficulties in hiring. The closest European survey is that of the European Commission, which asks companies why they do not produce more. Usually, it is demand that is deficient, there is a record of companies, more than a quarter, who say they cannot find workers.



At first sight, therefore, tensions are twice as great in the United States as in Europe. However, a more attentive reading yields a more contrasted view. The level in the United States is exceptionally high, 3.0 standard deviations above the long-term average. In the case of Europe, the “normal” level is much lower, so the last figure is 3.9 standard deviations above the long-term average. The situation is even more unusual than in the United States.

And off we go, one more S-chart that eloquently illustrates this. The last European point is totally to the right (historical high) the American point is almost there.



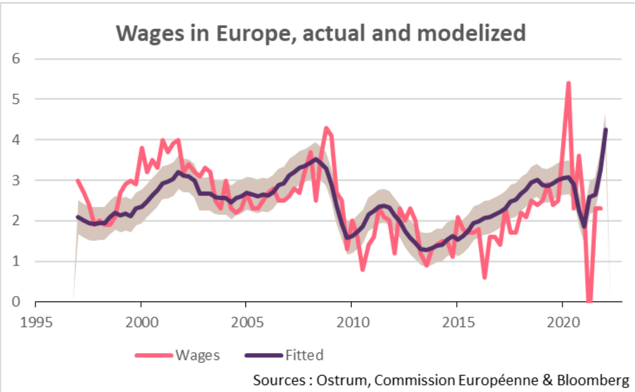
We can also mention the quarterly survey in the INSEE industry, on French companies: 61% of them say they have recruitment problems. Needless to say, this is a historic record. In the agri-food industries, we are even at more than 72%.

What about wages?

Let us look at the future dynamics of wages in Europe. There are normally three factors that influence wage formation:
- The level of unemployment. The famous Phillips curve, which explains how the employee/employer ability to negotiate is distorted.
- The level of inflation. That tells us an idea about what negotiators are anticipating.
- The margin level of companies telling us if they have the

capacity to increase wages.

We use these three arguments with delays on some variables. For example, wages react with 6 months of delay to inflation or unemployment rate, which corresponds to economic intuition. Over the period 1997-2019, we are able to explain more than 70% of the change in wages. That is more than honorable.



If we now look at what the model tells us about the future, we get salaries that exceed 4% annual growth at the end of this year, which would be a significant acceleration.

How far can this simulation go? "All models are wrong but some are useful" said George Box. The main problem with this model is that it is required to make forecasts using variables that are extreme, inflation at the highest point in history, unemployment at the lowest. Typically, econometric models can over-adjust in these cases if there are non-linearities.

The same George Box also said, "Statisticians, like artists, have the bad habit of falling in love with their models" It's pretty clear, though, that wages present an upside risk. All factors point that way. However, the proportion may be lower than the model suggests. The confidence range is 3.8% to 4.7%. That's still very much enough to be disruptive in many ways.

A scarecrow for hawks

Labor market levels are very different on the two sides of the Atlantic. The level of the main variables, for example the unemployment rate, is also on very different levels. On the other hand, the trends are similar: unemployment rates at the lowest level, hiring difficulties at the highest level, and a decline in wages.

This has two implications for the Eurozone. The first is that the labour pool may be very limited. In this case, companies would not be able to create the jobs they want and therefore, ultimately, would not be able to grow as much as they want. From an economist point of view this implies low potential growth.

The other side of the coin is prices. All the ingredients for wage growth are there. Will this progress be as marked as our model says? We shall see. But it is very likely that wages will shift upwards as they did in the United States. In this case, after persistent inflation figures at a high level, there would be unmistakable signs of secondary effects. In this case, the ECB's tough guys, the "hawks", would have all the arguments for a monetary tightening.

Stéphane Déo

Market review

A suffocated market

US inflation spurs fears of outsized monetary tightening.

US inflation is explosive. The US consumer price index, up 7.5% in January, reflects widespread pressures across the economy. The various measures of the CPI (median inflation, trimmed-mean index, sticky price index, etc.) excluding the largest relative price movements all estimate the underlying trend in prices at more than 7% in annualized terms over the last three months. The shelter component, for example, stood at 4.4% in January. However, this non-discretionary housing item accounts for fully a third of the household budget. Energy and food present considerable upside risks. Apparel prices sluggish for two decades suddenly register significant increases (1.1%m in January).

High inflation will quickly shift the debate within the FOMC from the "acceptable" pace of rate increases to preserve financial stability to the question of the "terminal" or neutral Fed funds rate. The level of long-term Fed funds rate, estimated by the FOMC participants, currently stands at 2.5%. Thus, central bankers agree on a neutral rate of 0.5% in real terms at the macroeconomic equilibrium resulting from growth in line with the potential of 1.8% and 2% inflation. It is now a matter of determining the interest rate consistent with the price stability objective. This level, which has no reason to be constant over time and independent of the economic situation or current supply constraints, is necessarily higher than the prevailing ‘neutral’ rate. It is for this reason that James Bullard, a voting member of the FOMC this year, pushes the idea of an immediate hike of the Fed funds rate. The current functioning of the money markets would rather require raising the rate of reverse repos and/or selling securities accumulated via QE programs. In that regard, the observed sharp increase in housing prices indeed suggests selling first Fed holdings in mortgage-backed securities (amounting to 2,651 billion $ to date). Either way, aside from the pace of Fed funds rate increases, the balance sheet reduction strategy will have to be addressed shortly.

Across the Altantic, Christine Lagarde and François Villeroy de Galhau are doing their best to tame market expectations which are now priced for two hikes in 2022. But, after the communication of February 3rd, their opinions clearly appear to be in the minority within the Governing Council, which seems to weaken the President’s influence and fans the widening pressure on peripheral debt spreads in particular. Pandora's box is open and all kinds of questions about the timing of the end of asset purchases, the reinvestment policy or the extent of rate increases are now on the table.

Market moves have been particularly extreme this week. The US 10y yield broke through the 2% ceiling after the US CPI release and hawkish comments from James Bullard. The fragility of the market resulted in a yield premium buildup ahead of the 10- and 30-year US bond auctions, which eventually did attract strong demand from final investors (or so-called indirect bidders). The trend remains for a flatter yield curve, as the 1.50% threshold on the 2-year yield failed to hold. Nevertheless, selling of long-term Treasuries resumed towards the end of the week until stocks pulled lower sending 10-year yields back down to 1.91%. The dollar has also been quite volatile. The knee-jerk reaction to buy back the greenback in response to a high inflation print triggered an instantaneous drop in the Nasdaq and a simultaneous peak on the 10-year bond yield. However, this initial spike in the US dollar was quickly reversed in favor of the euro, before renewed weakness in equities added support to the dollar. Thus, the dollar regained its status as a safe haven asset as markets reassess expectations for monetary tightening. Inflation breakevens (+6 bp over the week on the 10-year swap) are widening despite a more aggressive Fed, perhaps a harbinger of rising uncertainty on the equilibrium rate of Fed funds. Oil ($93 a barrel of Brent) is also providing support to short-dated TIPS.

In the euro area, sovereign spreads have been under pressure since the ECB meeting. Swap spreads are trading around 60 bps on the 10-year maturity. The price appreciation in the German Bund reflects the aversion to sovereign risk and related assets such as covered bonds. The consequences of the expected reduction in ECB monetary stimulus are more difficult to grasp. The first instinct of investors is to cut their long-standing overweight exposure to peripheral sovereign debt built on the idea of an irreversible support from the ECB, and thus to reposition on Bunds. Italian 10-year BTPs are trading above 160bp against German Bunds. The Greek bond spread reaction also reflects the non-eligibility of these debt securities to the ECS’s APP scheme, which days may now be numbered. The 10-year GGB has indeed widened 45 bps since the start of the month. The ECB is indeed confronted with the dreaded asymmetric risks.

As regards the credit markets, the widening trend sparked by protection buying trades (iTraxx IG at 66bp) is now weighing on corporate bond spreads. The market feels heavier, and the liquidity asymmetry is creating price gaps. The average spread on the euro IG market rose by more than 10bp last week. The rise in sovereign yields (5-year German at +0.08%) is redefining bond allocations. Outflows from credit funds continue. High yield is also shaken up as iTraxx XO remains close 2022 highs at 323 bps (330 bps at the peak). Outflows have been observed for several weeks on Eurohigh yield. Spreads increased 26bp last week.

Equity volatility remains high. European indices are posting a positive weekly performance despite pressure from bond markets. High dividend payers remain in high demand to the detriment of growth stocks.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	14-Feb-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.37%	-9	+21	+25
EUR Bunds 10y	0.26%	+3	+30	+43
EUR Bunds 2s10s	62.6bp	+12	+9	+19
USD Treasuries 2y	1.6%	+31	+63	+86
USD Treasuries 10y	2.01%	+9	+22	+50
USD Treasuries 2s10s	40.7bp	-21	-41	-37
GBP Gilt 10y	1.58%	+17	+43	+60
JPY JGB 10y	0.22%	+2	+1	+2
€ Sovereign Spreads (10y)	**14-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	48.17bp	+4	+7	+11
Italy	169.53bp	+14	+41	+34
Spain	101.49bp	+16	+28	+27
Inflation Break-evens (10y)	**14-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.04%	+4	+5	-6
USD 10y Inflation Swap	2.7%	+9	+6	-7
GBP 10y Inflation Swap	4.34%	+11	+11	+17
EUR Credit Indices	**14-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	119bp	+6	+23	+24
EUR Agencies OAS	60bp	+7	+13	+11
EUR Securitized - Covered OAS	62bp	+13	+18	+16
EUR Pan-European High Yield OAS	380bp	+12	+72	+62
EUR/USD CDS Indices 5y	**14-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	68bp	+2	+16	+20
iTraxx Crossover	334bp	+14	+76	+91
CDX IG	67bp	+2	+13	+18
CDX High Yield	369bp	+9	+59	+76
Emerging Markets	**14-Feb-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	389bp	+12	+12	+21
Currencies	**14-Feb-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.131	-1.189	-0.920	-0.6
GBP/USD	$1.353	-0.074	-1.090	0.0
USD/JPY	JPY 116	-0.467	-1.254	-0.5
Commodity Futures	**14-Feb-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$94.6	$1.9	$9.2	22.26
Gold	$1 865.4	$44.9	$47.4	1.98
Equity Market Indices	**14-Feb-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 399	-1.90	-5.66	-7.7
EuroStoxx 50	4 048	-1.75	-5.24	-5.8
CAC 40	6 819	-2.71	-4.53	-4.7
Nikkei 225	27 080	-1.31	-3.71	-5.9
Shanghai Composite	3 429	-0.02	-2.62	-5.8
VIX - Implied Volatility Index	29.90	30.80	55.81	73.6

Source: Bloomberg, Ostrum AM

Additional notes

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