MyStratWeekly

Market views and strategy

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N° 079 // **July 18, 2022**

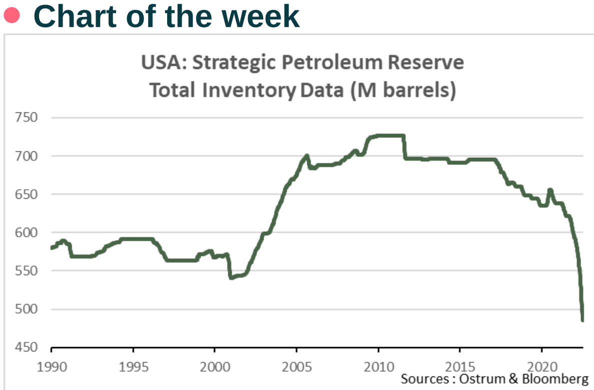
Topic of the week: Strong dollar or weak euro? American inflation

- **Summer has arrived, we offer two short articles instead of the theme of the week;**
- **The euro hit parity against the dollar last week. It is more a question of an appreciation of the dollar, which has risen against all major currencies, than of a weakness of the euro whose depreciation is less marked than for other currencies;**
- **Last week's US inflation figures again surprised on the upside. The details are not encouraging: inflation is persistent and widespread.**

Market review: Inflation and political crisis, the summer cocktail

- **Inflation at 9.1% could force the Fed to hike rates by 100 bps**
- **Italy crisis: Draghi offers his resignation, rejected by Mattarella**
- **Significant flattening of yield curves**
- **Swap spreads under pressure again**

Chart of the week



The United States is using its strategic oil reserves to lower prices at the pumps. The Biden administration is preparing for elections…

This decline in strategic reserves is more marked than what was announced by the administration. It is concomitant with the drop in oil prices on the world market.

However, the rate at which reserves are declining suggests that this effect can only be temporary.

Figure of the week

-2.6

Source : Ostrum AM

Chinese GDP contracted 2.6% in Q2 2022. The very aggressive lockdowns put in place have indeed had a significant impact on the activity.
The question now is about the strength of the rebound.

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• Topic of the week

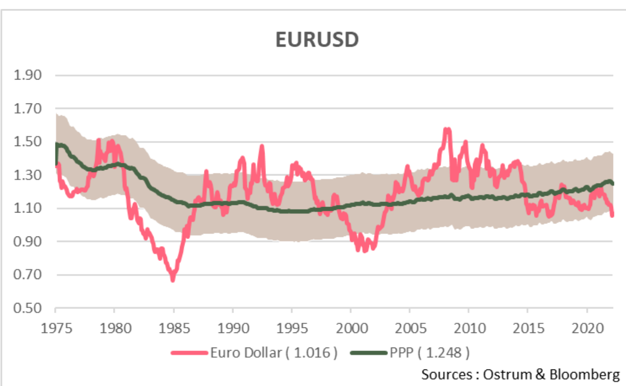
Strong dollar or weak euro?

The euro hit parity against the dollar last week. It has lost almost 20% of its value since the beginning of last year. Is the euro weak, or is the dollar too strong?

Plunge of the euro against the dollar

Last week, the euro hit parity against the dollar, a level we had not seen since December 2002, some 20 years ago. Since the beginning of last year, when the euro was trading at 1.22 against the dollar, the depreciation is therefore a total of 18%.

The consequence is that the euro appears to be very undervalued against the dollar. Our Purchasing Power Parity (PPP) model yields a long-term equilibrium value of 1.248 against the dollar, which would give the euro a discount of around 20% against its fundamental value.



As usual, however, it should be stressed that these PPP models, while they are a very good long-term anchor, are not very relevant in the short term. On the one hand the spot price can deviate very widely, a 40% gap is not impossible. On the other hand, the return force towards the PPA is very slow and the spot price can diverge for a decade. The PPP must therefore be considered as a long-term anchor.

The other currencies also

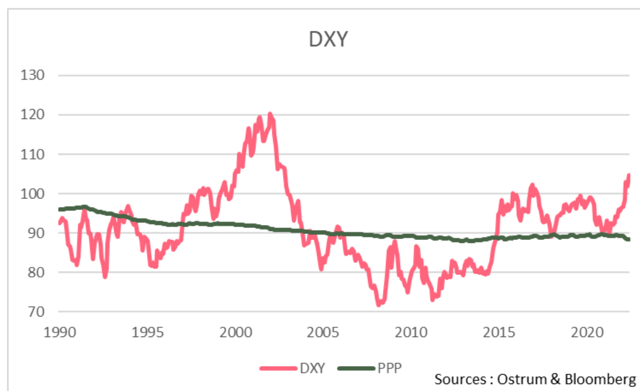
The question then is whether the euro has depreciated or the dollar is too expensive. We have replicated the PPP exercise for DXY currencies. The DXY is a widely used index that reconstructs a dollar exchange rate against the six major currencies (each weighted by its importance). The result is shown in the table below.

	Spot	PPP	Deviation *	Weight
EUR	1.02	1.25	22.8%	57.6%
JPY	0.01	0.01	72.2%	13.6%
GBP	1.20	1.61	34.7%	11.9%
CAD	0.77	0.87	12.3%	9.1%
SEK	0.10	0.16	63.0%	4.2%
CHF	1.02	1.14	11.3%	3.6%
DXY	104.69	79.77	31.2%	

* positive == USD overvalued

The conclusion is that the six currencies are very much below their PPP against the dollar. The dollar is expensive against each of these currencies. The euro is in the pack with its c25% undervaluation, so there is no particular weakness in the European currency that has held up better than the yen, the Swedish krona or the pound.

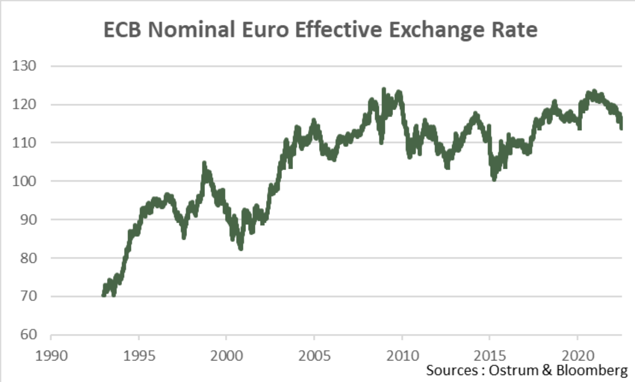
We have taken the logic a little further by reconstructing, from the calculations of the six currencies, a PPP for the DXY which is reproduced on the chart below. The approach shows that the dollar has appreciated enormously against the basket of currencies since the beginning of last year when it was at a value very close to the PPP.



The euro as a pivot?

Another way to look at the problem is to use the effective exchange rate of the euro. In economist's jargon, the effective exchange rate refers to the exchange rate of a currency, the euro in our case, against a basket of other currencies, the weightings of each of these currencies in the basket depend on the importance of trade. The concept is particularly useful for measuring a country's export competitiveness price.

The calculations are a bit cumbersome, and we therefore use the ECB index which takes into account 43 different currencies. The result is shown on the graph below.



Admittedly, since its most recent high at the end of 2020, the effective exchange rate of the euro has fallen by about 8%. But, on the one hand, the decline is much less dramatic than the 18% lost against the dollar. On the other hand, the absolute level remains high compared to the long-term average, we are 8% above the long-term average.

Here too, the euro seems to be in the middle of the pack.

Conclusion

Compared to the other major currencies, the depreciation of the euro is rather average. The analysis thus tends to show that we are not really in the presence of a weakness of the euro, even if everything is always relative for currencies, but rather a very strong appreciation of the dollar.

Stéphane Déo

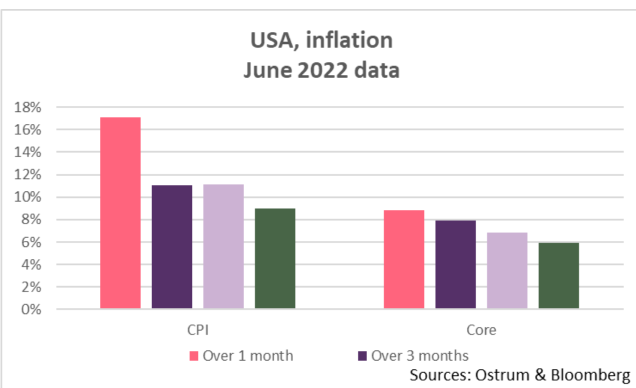
American inflation: all bad

American inflation again surprised on the upside in June. We propose several approaches from the local Feds to analyze these figures. The conclusion is clear: high and persistent inflation.

Facts: acceleration

U.S. inflation in June, released on July 8, stood at 9.1% against expectations at 8.8%. This is the highest figure since November 1981. Core inflation was published at 5.9% while the market was expecting 5.7%; it's down slightly from 6.5% in March.

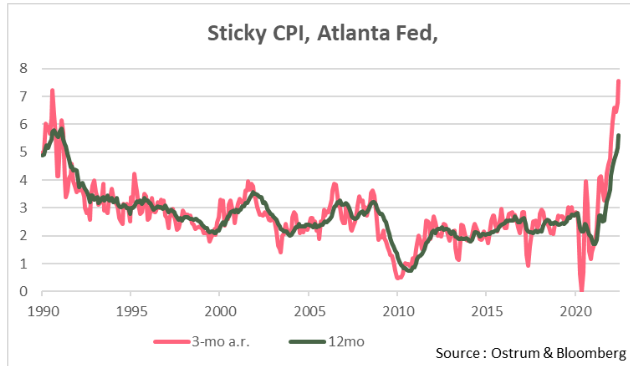
Nevertheless, as the chart below shows, inflation continues to accelerate for both the CPI and core. Inflation over the past month was higher than that of the last three months, which was higher than on the year. The beginning of the slowdown in price increases that seemed to emerge in recent months has been totally invalidated by the June figures.



Inflation memory: "Sticky"

An interesting first approach is proposed by the Fed of Atlanta which calculates a "sticky" index. This is a sub-index that takes into account the least volatile components, an alternative to the "core" approach.

The following graph shows the evolution of the index. The annual change in the index, "sticky" inflation, was 5.6% in June, close to its 1991 all-time highs. The change over the last three months is at 7.6%, the highest since the data was available.

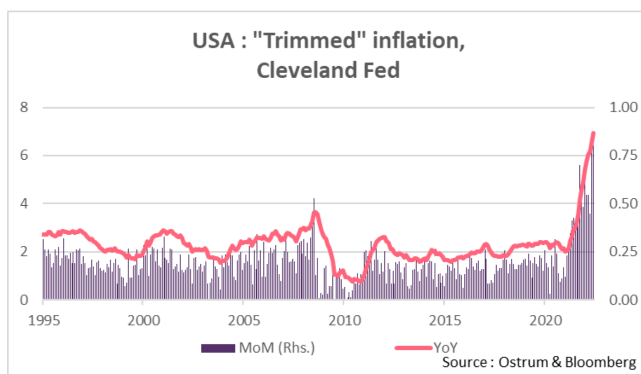


The figures confirm the very rapid acceleration in recent months. No reduction in the trend, quite the contrary. As the indicator focuses on sectors with high inertia, this also implies that inflation should not tend to fall rapidly. So there is a "memory effect" that should help make inflation persistent.

Distribution: "Trimmed"

Another indicator to watch is the Cleveland Fed's "trimmed" index. Each month, the index removes the largest increases and decreases. The idea is that these extreme variations are mainly due to short-term aberrant effects.

Again the change in the index is extreme, 6.9%, without any comparison with the levels recorded over the last 25 years.



This implies that, over and above some very dynamic components such as energy, a large number of sectors are experiencing very high inflation. Put another way, inflation has spread in a totally unusual number of sectors.

Stéphane Déo

Market review

Inflation and political crisis, the summer cocktail

Inflation could force Fed to hike rates 100bp, like BoC, as Italian political risk returns to haunt ECB and markets

The risk of recession has dominated the markets for several weeks now. The contraction of the Chinese economy (-2.6% in the second quarter) quickly translated into a sharp drop in oil prices. Meanwhile, monetary tightening via a 100 bp hike in Fed funds is being mooted after the June CPI inflation release, which spurred another bout of yield curve flattening. In the euro area, the scenario of a political crisis in Italy seems to be unfolding. Prime Minister Mario Draghi has put his resignation in the balance in the hope of preserving the government of national unity. Italian sovereign debt spreads are rising again to around 220 bp on 10-year bonds while the contours of the ECB's Transmission Protection Mechanism are yet to be determined. The recent improvement in credit markets is already fading under the effect of renewed tensions on swap spreads. As regards equity markets, the first Q2 earnings releases are colliding with expectations for further monetary tightening. The S&P 500 lost nearly 1% over five trading sessions despite a 2% jump last Friday.

Inflation remains at the heart of the concerns of central bankers at the Fed. Annual inflation stood at 9.1% in June, above the most pessimistic forecasts. Core inflation, which excludes volatile items, has indeed slowed to 5.9% (June) but its monthly increase (+0.7%) is the largest for a year. The diffusion of price pressures is indisputable. High prices for services, including housing and health costs, create strong price inertia that is difficult for the central bank to combat. In addition, retail sales picked up in June (+1%). Household demand for credit, still sustained (+$22 billion in May), has not weakened since the start of US monetary tightening. The Fed will tighten further, so that a 100 bp hike at the July FOMC meeting is now in play. The slight decrease in inflation expectations seen in the household surveys (U of Mich, New York Fed) is nevertheless good news, which reduces the probability of such a large Fed funds rate hike. That said, wage expectations from the same consumer surveys continue to rise, as the US labor market remains tight.

In the euro area, a political crisis is brewing in Italy. The M5S has pulled its support to the national-unity government in power since February 2021. President Sergio Mattarella rejected the resignation of Mario Draghi in a bid to avoid a political crisis by keeping him in office until the elections scheduled for the start of 2023. But, the Lega and Forza Italia are now calling for early elections. This precarious situation places the ECB in a dilemma. The Central Bank is about to unveil its intervention tool, the main beneficiary of which would be... Italy, but the ECB is only acting to ensure a uniform transmission of its policy and not to correct the asymmetrical risks generated, moreover, by a political crisis. These political stakes crystallize the criticisms, from German policymakers in particular. In addition, inflation in the euro area shows no signs of slowing down. Price pressures fuel wage demands so that second-round effects cannot be ignored.

Yield curves flattened sharply over the past week by 18 bp on the US 2-10 year and 15 bp on the Bund. The possibility of a 100 bp hike in Fed funds at the end of the month, which was unthinkable before the BoC's last decision (+100 bp), induces upward pressure on the 2-year (3.15%). Break-even inflation rates did not rise, however. On the contrary, the prospect of renewed lockdowns in China weighed heavily on crude prices and market inflation forecasts. The expected slowdown is also weighing on long-term bond yields. In the euro area, the Italian situation is fuelling demand for Bunds. On short-term maturities, the expected 25 bp rise in rates seems insignificant in view of the inflationary risk. While core sovereign spreads have held up well, the widening in Italian BTPs (about 220 bp) is causing upward pressure on Iberian bond spreads.

Tensions in the European credit market were revived by the rise in swap spreads. The Schatz is trading around 84 bps against swap, up 4 bps on the week. The widening is explained by a lack of collateral which amplifies the aversion for Italian sovereign risk. The widening in swap spreads, which is observed on all maturities, could trigger a new phase of widening of European credit spreads. Euro IG credit is currently trading at 207bp versus Bund. Despite the rebound in risky assets at the end of the week, the demand for protection remains very strong. The iTraxx Crossover is thus trading again above 600bp. High yield in euros is quoted at 660 bp.

On the equity market, the first banking publications were received to varying degrees by the markets. Overall, upside surprises are the majority for the first 33 publications in the S&P 500 published. Turnover shows aggregate annual growth of 7%. Friday's 2% bounce does not erase the weakness from the start of the week. The S&P 500 is down 1% in five sessions, and big tech stocks are losing up to 4%. The Euro Stoxx 50 floats but the Asian markets (Hang Seng -6.5%) are impacted by the Chinese economic risk.

As for currencies, the euro-dollar traded below parity, with the dollar still benefiting from its status as a safe haven.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	18-Jul-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.53%	+9	-57	+115
EUR Bunds 10y	1.21%	-3	-45	+139
EUR Bunds 2s10s	67.7bp	-12	+12	+24
USD Treasuries 2y	3.15%	+8	-3	+242
USD Treasuries 10y	2.96%	-4	-27	+145
USD Treasuries 2s10s	-19.6bp	-11	-24	-97
GBP Gilt 10y	2.13%	-4	-36	+116
JPY JGB 10y	0.24%	-1	-3	+1
€ Sovereign Spreads (10y)	**18-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	62.74bp	+1	+5	+25
Italy	215.91bp	+20	+24	+81
Spain	126.06bp	+17	+18	+52
Inflation Break-evens (10y)	**18-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.46%	+7	+3	+40
USD 10y Inflation Swap	2.69%	+5	-21	-9
GBP 10y Inflation Swap	3.95%	-4	-13	-22
EUR Credit Indices	**18-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	207bp	+2	+19	+112
EUR Agencies OAS	84bp	+4	+10	+35
EUR Securitized - Covered OAS	94bp	+5	+14	+48
EUR Pan-European High Yield OAS	660bp	+14	+127	+342
EUR/USD CDS Indices 5y	**18-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	120bp	+2	+11	+72
iTraxx Crossover	593bp	+11	+45	+351
CDX IG	90bp	-1	-10	+41
CDX High Yield	531bp	+4	-47	+238
Emerging Markets	**18-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	593bp	+55	+105	+224
Currencies	**18-Jul-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.015	1.066	-3.463	-10.8
GBP/USD	$1.196	0.572	-2.391	-11.6
USD/JPY	JPY 138	-0.572	-2.286	-16.7
Commodity Futures	**18-Jul-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$103.4	-$3.8	-$7.0	38.17
Gold	$1 721.1	-$12.9	-$117.6	-5.91
Equity Market Indices	**18-Jul-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 863	-0.93	5.12	-18.9
EuroStoxx 50	3 522	1.45	2.43	-18.1
CAC 40	6 114	1.97	3.94	-14.5
Nikkei 225	26 788	1.02	3.18	-7.0
Shanghai Composite	3 278	-1.07	-1.17	-9.9
VIX - Implied Volatility Index	24.76	-5.39	-20.46	43.8

Source: Bloomberg, Ostrum AM

Additional notes

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