Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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New guidance from Jackson Hole?

Key Points

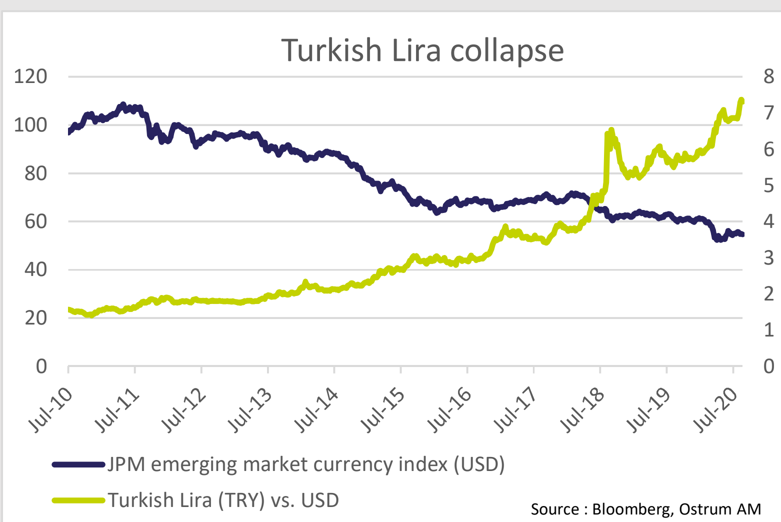
- **Jackson Hole: the Fed may unveil policy options**
- **Stable yields, tighter sovereign spreads**
- **US equities at record highs powered by FANG**
- **European credit outperforms US credit**

Financial markets were well oriented in August despite ongoing concerns about the evolution of the epidemic. Stock indices are up 5% in Europe. The S&P 500 is up about 4% from the end of July.

Risk-free rates rebounded in the US, particularly at the long end of the curve (+11bp on 10-year notes). Bunds oscillate about -0.50% whilst steepening pressure in the US pushed 30-year Treasury yields back above 1.30%. TIPS also benefitted from the upside surprise on the July CPI. Credit spreads tightened in part due to lower seasonal supply. European high yield followed on from risky assets. Conversely, US corporate credit appears less supported by the Fed. Emerging bonds labelled in USD keeps outperforming at 422bp spread vs. USTs.

The dollar slide continued. The euro is trading above $1.18. CAD appreciated towards 1.315 against the greenback. Gold's acceleration to the upside (beyond $2000 in early August) has given way to greater volatility in past few weeks.

Chart of the week



The Turkish Lira keeps plunging despite broad signs of stabilization across EM currency markets. The economic crisis, the challenging situation in neighboring Lebanon, restrictions to trade liras and the international lack of confidence in Erdogan's regime sparked capital outflows.

The Central Bank, using highly expansionary policy, magnified the downside risk on the Turkish Lira. The M1 monetary aggregate is up 70% YTD. Meanwhile, Turkey's gross FX reserves have halved.

The sustainability of the recovery remains an open question

Concerns regarding the evolution of the epidemic continue to dominate headlines but it is undeniable that the US economic situation has been improving. Manufacturing surveys for the month of August confirmed that activity is gaining traction. Regional Fed surveys (Empire, Phil Fed), July ISM and August PMI (53.6) depict a net rebound since the April low. Activity in services is also more vigorous. Return to employment accelerated so that unemployment rate declined to 10.2% in July. The housing sector is a driving force behind the recovery. Homebuilders' confidence remains very elevated (NAHB at 78). Housing starts and permits rose sharply in the past three months. Housing starts (1496k at annual rate) are back to pre-crisis levels.

That said, the sustainability of the US recovery remains questionable at this juncture. Initial jobless claims climbed back above 1.1mn last week. Unemployment duration is increasing all the more so that the number of bankruptcies is up since late June. It is estimated that up to a quarter of jobs lost during the crisis may not be recouped. Household consumption sustained by large Federal transfers since March may slow as inflation creeps higher with the rebound in apparel, energy and auto prices. Part of pent-up demand built-up in the confinement period has already been consumed. The 5.6%m rebound in household spending in July may start to wane (+12.5%m is the consensus estimate for August). Auto sales climbed back near 15mn units at annual rate still shy of the 16-17mn that prevailed before the Covid crisis. Shenanigans in Congress so far prevented the implementation of a new fiscal stimulus plan, which should include some form of extension of federal unemployment benefits which expired at the end of July. The dire financial situations in several US states will prevent stimulus to be deployed without federal aid. A halving of weekly benefits to $300 is being debated.

Virtual, yet crucial, Jackson Hole

The Jackson Hole symposium scheduled on 27-28 August will be held virtually for the first time. The event is usually a great opportunity for central bankers to pre-announce possible change to policy in the months ahead. Fed policymakers are widely expected to touch upon yield curve control policies. The uncontrolled increase in US government deficits obliges the Fed to absorb much of the US government borrowing needs, especially as foreign demand for Treasuries collapsed early on this year. In this situation (sometimes coined 'fiscal dominance'), the Fed is no longer truly in control of the money supply, which is de facto dictated by government budget deficits. The possibility of yields targeting also carries some problems in terms of economic cycle management. The cushioning effect of lower interest rates when demand declines would disappear, which could be conducive of greater volatility, especially if private sector borrowing continued to expand. The Fed could also reinforce its forward guidance by committing to keep rates at zero for longer than 2 years. The inflation objective may be amended shortly to take into account the prolonged period of sub-target inflation. The Fed appears quite open to overshooting its 2% goal.

Neutral stance on rates

In bond markets, neutrality prevails in terms of duration. The possibility of yield curve control is comforting our neutral stance on US 10-year bonds. That said, as the maturity of US Treasury bond issuance increases as announced in early August, 10s30s spread wideners (71bp) still make sense in our opinion. German Bunds oscillate about -0.50% and tend to underperform swaps in the past few weeks. Curve moves are quite limited. Swap spreads are within 24 and 30bp. Japanese bonds are least attractive in G4 space. That said, JGB swapped back into USD offer a significant pickup against US Treasuries.

Expansionary monetary policies have lowered volatility, which fosters carry trades on spread assets. In fact, spreads on peripheral sovereign bonds and euro credit continued to narrow through the summer. Investor surveys indeed indicate a broad-based bullish consensus on peripheral debt. Primary market issuance seasonality and ongoing ECB buying underpin these markets. Spreads on French 10-year debt narrowed by 3bp since the end of July. Furthermore, Italy is trading at 145bp spreads vs. Bunds on 10-year maturities, 9bp less than at the start of the month. High-grade credit in euros returned 0.51% so far this month thanks to financial sub debt and good performance from select industrial sectors. Institutional accounts have little choice but to accumulate credit holdings to reduce book yield erosion. Conversely, US credit appears less supported by the Fed than at the height of the crisis. The net amount of corporate credit held be the Fed is a mere $44b, just $10b more than end-of-May holdings. Both corporate credit facilities have total capacity of $750b, which hence may never be reached as part of the Fed's current operations is to reallocate ETF holdings into eligible single-name corporate bonds. Fed action is likely a key reason behind the underperformance of US credit.

Lastly, in equity space, major US indices (S&P, Nasdaq) keep making record highs powered by top-tier big technology companies. The FANG+ index is up 71% in 2020 whilst the rest of the pack lost ground.

Main Market Indicators

G4 Government Bonds	24-Aug-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.68 %	-2	-3	-8
EUR Bunds 10y	-0.49%	-4	-4	-31
EUR Bunds 2s10s	19 bp	-2	-2	-23
USD Treasuries 2y	0.15 %	+0	+0	-142
USD Treasuries 10y	0.65 %	-4	+6	-127
USD Treasuries 2s10s	50 bp	-4	+5	+15
GBP Gilt 10y	0.21 %	0	+7	-61
JPY JGB 10y	0.03 %	-2	+1	+4
€ Sovereign Spreads (10y)	**24-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	30 bp	+1	0	0
Italy	144 bp	+5	-1	-16
Spain	82 bp	+4	+2	+16
Inflation Break-evens (10y)	**24-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	59 bp	-3	-1	-
USD TIPS	169 bp	+3	+19	-10
GBP Gilt Index-Linked	307 bp	+9	+13	-5
EUR Credit Indices	**24-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	116 bp	+1	-12	+23
EUR Agencies OAS	49 bp	+1	-2	+5
EUR Securitized - Covered OAS	38 bp	+1	-1	-3
EUR Pan-European High Yield OAS	464 bp	+6	-28	+160
EUR/USD CDS Indices 5y	**24-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	54 bp	0	-4	+10
iTraxx Crossover	328 bp	-13	-18	+121
CDX IG	66 bp	-1	-4	+21
CDX High Yield	384 bp	-14	-79	+104
Emerging Markets	**24-Aug-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	422 bp	+9	-25	+132
Currencies	**24-Aug-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.180	-0.6	+1.21	+5.06
GBP/USD	$1.307	-0.27	+2.14	-1.47
USD/JPY	¥105.9	+0.09	+0.23	+2.53
Commodity Futures	**24-Aug-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$44.9	-$0.5	$1.1	-$17.1
Gold	$1 931.5	-$56.0	$29.4	$408.7
Equity Market Indices	**24-Aug-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 419	1.10	6.33	5.83
EuroStoxx 50	3 332	0.78	0.63	-11.04
CAC 40	5 008	0.72	1.04	-16.23
Nikkei 225	22 986	-0.48	1.03	-2.84
Shanghai Composite	3 386	-1.55	5.91	11.00
VIX - Implied Volatility Index	22.59	5.81	-12.58	63.93

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