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Powell ruling out negative rates

Key Points

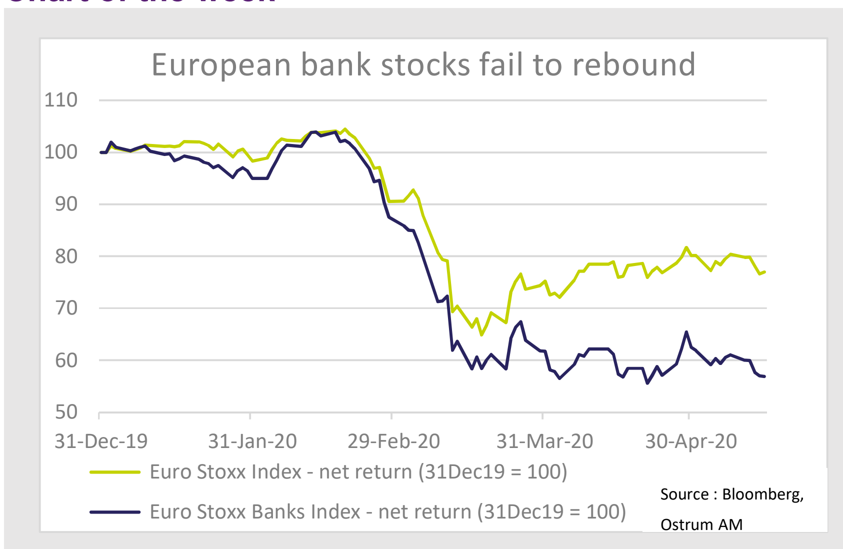
- **Renewed weakness in European equities**
- **Curve flattening – T-note yields drop below 0.70%**
- **Sovereign spreads stabilize**
- **Credit holds up well whilst US high yield remains under pressure**

European equities plunged by 5% in the wake of Wall Street, which limited its losses to just 2% last week Financials and cyclicals took a hit. Gold benefitted from increased risk aversion. The US dollar was also a safe haven.

Jerome Powell is pushing back against negative rates hence fostering curve flattening. The yield on 10-year Treasury notes fell to 0.64%. Bunds -0.54% follow on from US curve flattening. The 2s10s spread shrank by 4bp last week. Sovereign spreads were stable, or even slightly tighter in Spain and Portugal thanks to ECB buying.

In parallel with the drop in stock markets, synthetic credit indices widened. The spread on iTraxx crossover increased to about 540bp. Corporate bonds proved more resilient. The rise in default rates in the US maintains pressure on spreads. In turn, emerging market debt denominated in US dollars were quite stable within 600bp spreads. In currency space however, the weakness in Brazilian real continues (5,86 vs. the USD).

Chart of the week



The banking sector continues to destroy shareholder value. About three-quarters of banks have announced reduced payouts or script dividends. Stock prices are still some 4% their March 18 level which is the market's low in 2020.

The recession raises risk-weighted assets (hence capital requirement). The P2R reform provides incentives for banks to issue subordinated debt (25% Tier2, 18,75% AT1). Needs for Tier 1 and Tier 2 issuance may fetch tens of billions of euros. If market conditions prove unhelpful, bank stocks may face further weakness.

Recession and financial risks

The series of bad economic data continued last week and stock markets are seemingly paying attention again. In the US, retail sales plunged by 16.4%m in March. Ex-volatile items, household spending fell 15.3%m despite increases in online spending. On top of social distancing measures, the need to reduce debt, little tourism activity and the rise in unemployment contributed to the shortfall in retail spending. The University of Michigan household survey revealed a rise in perceived inflation which may be traceable to dearer food prices. Initial jobless claims (2.9mn last week) are gradually coming down but job destruction may still exceed the 13mn threshold in May. The worst is yet to come. In fact, 40%pf Americans which made less than $40k annually are now unemployed. For the most financially fragile groups, the $600 weekly payment from the Federal government on top of state-level income security schemes make up all of the income loss. Hence, current demand decline does not reflect output losses. In its semi-annual financial stability report, the Fed indicated that the pandemic will result in heavy financial losses affecting banks and other financial institutions. Leverage of hedge funds may cause disorderly fire sales of assets to meet margin calls. The rise in default rates in risky loan markets (leveraged loans, mid-market) will weigh on lenders including CLOs. The Fed's intervention is no panacea. Jerome Powell recalled last week that monetary policy cannot be a substitute to government spending. Massive MBS purchases since March indeed caused rising margin calls for lenders have hedged their interest rate risk for instance.

In Europe, the ruling of the German constitutional court revived institutional tensions at a time when European leaders seek to secure a recovery fund around three pillars. The priority will be to fund public investment in green energy and digital transformation. Furthermore, governments will aim at crowding in private investment on strategic activity and reinforce the capital of sound strategic corporations. Lastly, programs including research that proved useful during the crisis will be reinforced.

Equities dropped 5% in Europe

In financial markets, European markets have dropped back by 5% last week. Sector performances indicated a pullback in cyclical stocks (automobiles, basic resources, construction) and underperformance of the financial sector. The capital shortfall of financial institutions and some non-financial corporations entail dilution risks ahead. The health care sector performed better than the market but still lost 1% last week.

Since the technical rebound in Euro Stoxx 50 between March 18th and March 26th, the index oscillates between 2620 and 3000. The 2q20 earnings season could lead to lower prices especially if there is a pull back in US equity markets. The current broad consensus seen in individual investor survey and short speculative positioning may however limit downside risks. Even if the S&P 500 does not retest its March lows, the benchmark equity gauge which has been supported disproportionately by the GAFAM group may have to adjust to the underlying economic reality.

In bond markets, the nascent steepening pressure cam to an abrupt halt as equities fell last week. The return of risk aversion sparked a rally in US Treasuries bringing 10-year yields down to 0.64%. Jerome Powell reaffirmed that negative rates are not an option at this juncture, which may have also fanned curve flattening. Money markets estimate a 10% probability of negative rates next year. The reserve Bank of New Zealand is openly considering negative rates as a potential next step. These market forecasts continue to support gold prices which remain solidly above $1700. MBS spreads (70bp) widened out by 29bp last week. Default risk and strong mortgage refinancing activity require an elevated yield premium. Furthermore, MBS purchases since March have increased margin calls at lenders which had hedged their interest rate risk. In credit markets, the tightening trend continued despite heavy supply. The average spread stands at 208bp (-4bp). US high yield is still under pressure. There are 35credit events in January-April period in the US, equivalent to 5.45% of issuers in the past 12-month period.

In the euro area, Bunds followed on from US-led flattening to trade at -0.54% late last week. Sovereign spreads remain stable with even modest tightening in Spain and Portugal. Italian 10-year BTPs are trading near 240bp. The Italian government will likely tap the ESM credit line, to the tune of 35b maximum. The potential use of ESM funds weighed on supranational debt spreads. In addition, the Italian Treasury may reduce T-bill issuance to tap the 2-3y maturity area as upcoming Target Long-term refinancing operations may spur demand for short-term bonds.

In European credit markets, spreads are trading about 200bp against Bunds (+7bp last week). Final investor demand for corporate bond funds has slowed somewhat since the beginning of April. High yield is trading about 660bp. European default rates have risen but remain below 2% in the 12 months to April. The pullback in equity markets sparked widening in iTraxx XO spreads.

Lastly, the pushback against negative rates in the US and lower equities entail support for the US dollar. In turn Sterling is down 2% as Brexit uncertainty remains a major source of uncertainty.

Main Market Indicators

G4 Government Bonds	18-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.75 %	0	-7	-15
EUR Bunds 10y	-0.55%	-4	-8	-36
EUR Bunds 2s10s	20 bp	-3	0	-21
USD Treasuries 2y	0.14 %	-4	-6	-143
USD Treasuries 10y	0.64 %	-7	+0	-127
USD Treasuries 2s10s	51 bp	-3	+7	+16
GBP Gilt 10y	0.21 %	-6	-10	-62
JPY JGB 10y	-0.01 %	-2	-3	+0
€ Sovereign Spreads (10y)	18-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	51 bp	+0	+0	+20
Italy	233 bp	-6	+6	+73
Spain	127 bp	-6	-2	+61
Inflation Break-evens (10y)	18-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	24 bp	-6	-7	-
USD TIPS	109 bp	-3	+7	-70
GBP Gilt Index-Linked	284 bp	+2	+8	-27
EUR Credit Indices	18-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	199 bp	+7	+0	+106
EUR Agencies OAS	73 bp	-2	-2	+29
EUR Securitized - Covered OAS	60 bp	-7	-7	+19
EUR Pan-European High Yield OAS	680 bp	+10	+24	+376
EUR/USD CDS Indices 5y	18-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	87 bp	+3	+2	+43
iTraxx Crossover	524 bp	+17	+19	+318
CDX IG	95 bp	+3	+6	+50
CDX High Yield	681 bp	+41	+68	+401
Emerging Markets	18-May-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	579 bp	-4	-30	+288
Currencies	18-May-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.081	+0	-0.57	-3.75
GBP/USD	$1.210	-1.94	-2.9	-8.74
USD/JPY	¥107.3	+0.34	+0.34	+1.19
Commodity Futures	18-May-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$33.8	$4.2	$2.2	-$29.7
Gold	$1 762.1	$64.8	$67.5	$239.3
Equity Market Indices	18-May-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	2 864	-2.26	-0.38	-11.36
EuroStoxx 50	2 837	-1.64	-1.79	-24.26
CAC 40	4 381	-2.43	-2.62	-26.71
Nikkei 225	20 134	-1.26	1.19	-14.89
Shanghai Composite	2 875	-0.67	1.30	-5.73
VIX - Implied Volatility Index	30.59	10.95	-19.82	121.99

Source: Bloomberg, Ostrum Asset Management

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