MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 005 // **11 January 2021**

Topic of the week: Where is the Bund going?

- **ECB's monetary policy has anchored yields at a low and stable level.**
- **As long as this policy remains unchanged, the Bund is to remain in a tight range of -0.65% to -0.35%.**
- **On a longer horizon however, a change in ECB's stance could be associated with more sizeable curve moves.**
- **The fundamental value is more elevated, we find it North of 1% in the case of the Bund.**

Market review: Euphoria and chaos

- **Reflation trade collides with unrest in Washington**
- **Small caps, steepeners and TIPS outperform**
- **T-note yields rise to 1.10%**
- **Euro sovereign and credit spreads down**

Chart of the week

Since April, the US 5-10 year yield spread has increased sharply to reach its highest level since December 2015. This steepening of the US yield curve results from the rise in long-term rates following improved growth perspectives and anticipation of somewhat higher inflation. Short-term rates, on the other hand, remain relatively stable at a very low level due to the guidance from the Federal Reserve that its rates will remain close to zero for a long time. This steepening was hastened last week following the results of the senatorial elections in Georgia which gave Joe Biden the majority in Congress. This increases its ability to adopt a new stimulus package, likely to increase the financing needs of the US Treasury, which has weighed more on long-term rates.

Figure of the week

25

Democrats step up pressure on Vice President Mike Pence to invoke the 25th Amendment to impeach Donald Trump following his role in riots on Capitole Hill.

Source : Ostrum AM

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Topic of the week

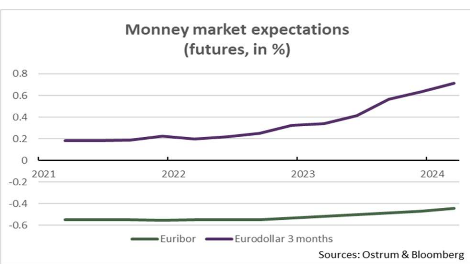
Where is the Bund going?

ECB's monetary policy has anchored yields at a low and stable level. As long as this policy remains unchanged, the Bund is to remain in a tight range of -0.65% to -0.35%. On a longer horizon however, a change in ECB's stance could be associated with more sizeable curve moves as the fundamental value is more elevated, we find it North of 1% in the case of the Bund.

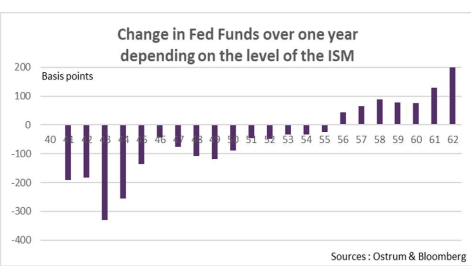
What is the curve telling us?

Monetary policy

The first story is one of **a monetary policy that remains extremely lose for an extended period of time.** Three-month Euribor contracts are consistent with an increase of a mere 2.5 basis points over the coming two years. US rates are not much better with only a dozen basis increase points over two years.



With the ECB's and Fed's communications in mind, this should hardly come as a surprise. Still, this is totally at odds with recent history.

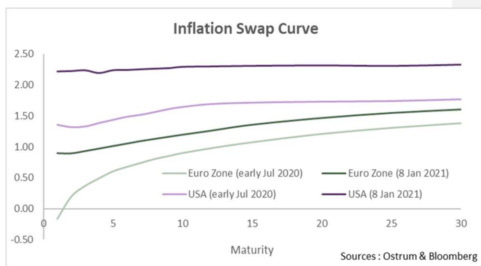


Central Banks' interest rates tend to move with the cycle as demonstrated by the chart above. The Manufacturing ISM is a reliable signal of the Fed Funds movements over the following twelve months. In a « normal » world, with the ISM currently standing at 60.7, one should expect the Fed Funds to gain almost 100 basis points over the coming year.

The market is thus assuming, rightly so we believe, that monetary policy is immune from the cycle for the foreseeable future.

Inflation

The second story is that inflation is not really an issue. It is worth highlighting however that the inflation curve has significantly been reassessed over the past few months. In the USA for instance, last summer the curve was telling us that we would have to wait a decade before seeing inflation returning to 2% Currently, the all inflation curve has migrated back above the 2% mark. As often, the corresponding change in Europe is more tepid. Here too though it is worth noting that the 10-year inflation swaps have moved from 0.8% at the end of Q2 last year to 1.15% now.

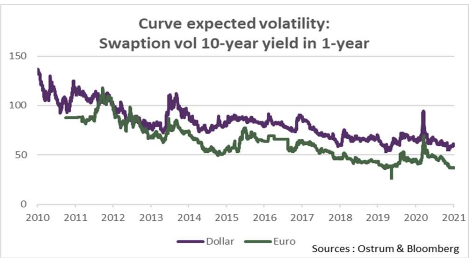


The message sent by the market remains however a Goldilocks one. No deflation Japanese style. This is obviously true in the USA, but to a large extent in the Euro Area since inflation there is expected to trend upward, albeit slowly, and settle in a range between 1% and 1.5%. There's no risk of overheating either. **A perfect scenario for Central Banks that will allow them to keep their very loose monetary policy.** This second story on inflation is very consistent with the market's view that Central Banks will remain pat for long.

We are far from convinced by this nice scenario and believe inflation could prove less well behaved (see our MyStratWeekly from December 7th "The Return of Inflation?"). Our chief economist Philippe Waechter is also of the view that inflation has a potential to surprise on the upside. The market for now, couldn't care less.

Long rates

Last story, with such a stable environment both in terms of monetary policy and in terms of inflation, it will come as no surprise that the markets expect little variations in long yields. **Expectations here too are quite stable indeed.** The chart below shows the market expected volatility on the long part of the curve (we use the "swaption vol" to facilitate comparisons between the US and Euro Area). Expected volatility is indeed at historical lows.



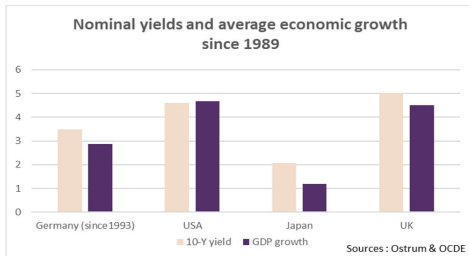
For the anecdote we can note that, with such limited changes, the Bund will not return into positive territory before 2033. In 12 years! The Treasury is also expected to remain in a 100 basis points range for the entire decade. **The expected increase in rates is indeed desperately slow.** In the case of the Bund, the market expects a -0.09% yield in ten years, a mere 47 basis points gain over the decade. As demonstrated by the chart below, this is one of the lowest expected change over a quarter of a century.

The market is thus expecting quite a calm scenario, with monetary policy on hold for long, inflation that settles at a low level and curves that should not move much. This scenario is very "Zen" and in sharp contrast with the recent history.

A fundamental approach

The classical approach to estimate the fair value of rates is based on the so called "golden rule". The idea is that interest rates should converge towards the level of economic growth. In real life this rule has proven to be very accurate as shown in the following chart.

The chart relies on US data as this allows to have a time series spanning more than 60 years. Using OECD data however, we can obtain for the past 30 years results for other countries. The signal is the same as the "golden" has proven quite accurate indeed here too.



Our fundamental model relies on that philosophy, with added sophistications; in particular we take into account flow of funds via data on Treasury purchases by foreigners and we use an error correction model to capture the short-term dynamic.

The issue with this approach is that over the past decade the actual yields have gradually diverged from their fundamental value. Remaining in the confine of the golden rule model, we would get a fair value for the US 10 year at 3.8% while our fundamental model is at 2.48%. In the case of the Bund we would have 1.2% on the pure golden rule approach, but a more realistic 0.37% with our fundamental model.

Those fundamental fair value might seem far from the truth. In the case of Germany however, a recent ECB study (see https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190612_1~1a3bede969.en.html) estimates that the QE has had the effect of driving down yields by about 90 basis points. Taking that into account our fundamental fair value would be closer to -0.50%, which is not that far from what you see on the screen. It is worth noting also that the QE effect wanes only slowly and will take more than 15 years, again according to the ECB's paper, to disappear.

If the fundamental approach remains relevant, it must be complemented by the effects of the extraordinary loose monetary policy currently implemented.

"The only game in town"

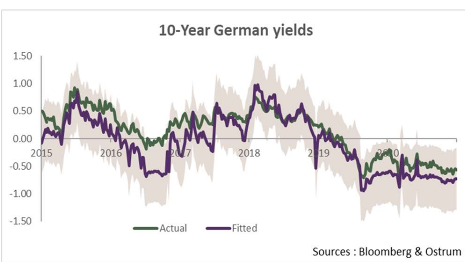
The fundamental approach must be augmented. In particular with monetary policy that put a ceiling on rates. This explains to a large extent the movements of the last quarter in 2020, despite mounting expectations of a recovery on the wake of the vaccine announcements and budgetary policies, rates have hardly moved due to the Central Banks interventions.
To make the point we will swing completely: let aside fundamental information and take into account only

monetary policy. **Can we have an analysis "soilless" getting rid of fundamentals and focusing exclusively on monetary policy?**

More specifically, we model the short part of the curve: ECB's rates and the slope of money market rates which embodies market's expectation of monetary policy. For the dedicated ones, we use a Nelson-Siegel approach to fit the short part of the curve. Then we use the output of the model to estimate a 10-year yield that would be consistent with this short part of the curve. The confidence interval is obtained by varying in a plausible way the parameters of the model.

A narrow range for the Bund as long as the ECB doesn't change its monetary policy.

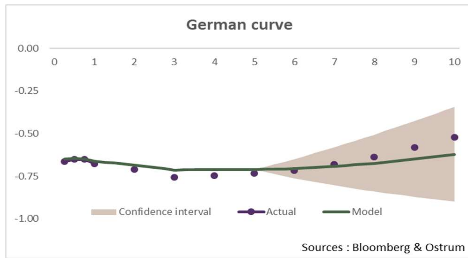
From a purely empirical point of view, the results are satisfactory. Our "soilless" approach is efficient. The average model error is small moreover, and more importantly, the actual yields tend to converge back to the prognosis of the model. To put it differently, the output of the model acts as point of reversion for the actual yields and it thus provides a good guidance for future market moves.



There are several conclusions to be derived from this exercise. First, over the past decade, **the information from monetary policy seems to explain almost all the movements in yields.** To borrow from El-Erian's last book title, monetary policy is indeed "The Only Game in Town".

Second, if we take into account the current shape of the short part of the curve, **it is difficult to justify Bund yields moving above -0.3%.**

The intuition behind this conclusion is simple: with short rates close to -0.65% and the curve being very flat up to five years, the degree of liberty for the longer maturity is limited. At the risk of being inconsistent, it is unwise to assume a steep curve on the five to ten-year section if the zero to five year is so flat. Hence, as long as the ECB doesn't change its policy nor its guidance, German yields have to hover around the current prints.



The issue with that approach, though, even if it provides presently the best fit, is that it is a very short-sighted one indeed. It does provide valuable guidance on the range for the Bund and the rest of the curve. But does not allow to draw trend: to the extent that monetary policy is lagging, the economic cycle future changes cannot be analyzed. If the economic cycle was to accelerate or if inflation was to increase, the ECB's monetary policy would have to adjust, even if, needless to say, this is not an issue in the short term. The first approach, using fundamental approach, would then become fully relevant once again to capture changes.

Conclusion: as long as the ECB doesn't change…

Short term stability

As long as the ECB doesn't change its monetary policy, monetary rates will remain where they are and the short part of the curve will remain totally flat. In such a situation, Bund yields should stay in a narrow band.

To be more precise, under current circumstances, we find that the probable range of variation for the Bund is -0.65% to -0.35%, which is not far from what has been the case over the recent past, an increase over that mark seems hard to justify.

We note that the Bund has indeed settled 90% of the time within that range since the beginning of last year. And even more so since the start of the pandemic.

Medium term risks?

Over a longer horizon however, the situation could be more complex with and equilibrium interest rates at a higher level. Even if a monetary policy change is highly unlikely over the near future, the equilibrium level of yield derived from fundamentals is much higher than the current prints. Moreover, at the time of writing, the scenario expected by the market is particularly benign and could lead to the need for a reassessment. The change could be violent.

Stéphane Déo

Market review

Euphoria and chaos

The reflation theme continues to be dominant across financial markets despite a deleterious political backdrop in the US. T-note yields rose to 1.10%. In Europe, as equities move higher, spread compression accelerated.

Financial markets have been in levitation so far this year. The outcome of the Georgia Senate elections revived the reflation investment theme, which shows in steepening strategies, exposure to index-linked bonds and US small cap stocks. Donald Trump's mandate is ending in chaos. Representatives and Senators from both sides of the aisle now call on Michael Pence to activate the 25th amendment of the Constitution to declare the President incapable of executing the duties of his office after he called for insurrection to block the validation of the electoral college vote. In turn, Donald Trump's latest decisions ordering delisting of Chinese companies from US markets only highlight his willingness to leave a land mine field ahead of Joe Biden as it relates to US-China relations.

On economic grounds, US growth, likely about 8%qa, was solid in the fourth quarter. Unemployment stabilized at 6.8%. Hours worked expanded at a 10.1% annualized rate in three months despite 140K jobs lost in December. Layoffs have been concentrated in the leisure and hospitality sector (-498k) but activity is strong in the rest of the economy. Manufacturing surveys (ISM at 60.2) point to strong growth. Service sector activity, most exposed to lockdown measures, was up at 57.2 in December. Consumer spending picked up from November with solid car sales topping 16mn at annualized rate.

In parallel, global trade continues to improve as evidenced by rising factory orders in Germany through November. Freight prices in Shanghai reflect strong trade flows. The situation in Europe is quite uneven. Economic surveys have been spotty (especially in services), and growth may roll over again in the early part of 2021. The vaccination effort, which is crucial to ensure the economic recovery, is faced with a new Covid variant and logistic difficulties.

The reflation trade goes hand in hand with the US fiscal outlook after Democrats secured a majority in Senate. Joe Biden's platform indicated 4T federal spending until 2024. The ensuing deficit increase sparked a run-up in T-note yields to 1.10%. Curve steepening continued as short-term yields remain anchored about 0% possibly until 2023. The Treasury quarterly refunding to be communicated in early February will be a determining factor for bond markets as T-bill issuance may be refinanced via long-term bonds ahead of tough discussions on the US federal debt ceiling. Yield targets may point to higher bond yields… until the Fed eventually steps in although Richard Clarida suggested no policy change last week. December FOMC minutes offered little guidance as regards asset purchase programs. The bond market will test the Fed's reaction function amid rising inflation. The oil price rise engineered by the Saudi Arabia output cut (-1mbpd from February) and the recent depreciation in the US dollar have underpinned the inflation expectations. Ten-year breakeven inflation rates stand above 2% (and even 2.29% on inflation swaps).

In the euro area, the new Bund benchmark was issued last week (-0.52% close). Despite rich valuations, Bunds barely reacted to upward pressure on US yields. January bond syndications have started with several public-sector deals (15-year BTPs, 10-year Irish bond). Bonds sold at spreads well below initial guidance. Spread tightening is fueled by institutional cash to invest and announcements reduction in net issuance this year. Indeed, Spain revised its net borrowing forecast down by €10b to €100b in 2021. Portugal also revised issuance projections lower. The 10-year Bono trades about 55bp spreads. In parallel, a German land managed to borrow €2b below 1% yield at 100-year maturity. Excess demand fueled by large ECB bond buying does complicate fundamental sovereign spread analysis. Inflation expectations also rose in the euro area despite currency strength. Breakeven inflation rates crept higher to the tune of 5bp.

Regarding corporate bonds, the average yield on euro IG hovers about 0.2%. Spreads narrowed 4bp last week to 88bp vs. Bunds. Strong primary market issuance seems to spur demand as spreads fall below initial estimates. High yield richened although valuations seem inconsistent with underlying credit risks in the context of the pandemic. One may wish to dial down exposure to European high yield bonds as spreads tighten (now 30bp below 5-year average in BBs). In turn, equity implied volatility, which remain somewhat elevated considering record index levels, does contribute to widening pressure in iTraxx crossover spreads.

Lastly, equities are up between 2 and 6% so far in 2021 with notable outperformance from the Russell 2000. The pickup in the dollar however raises question. The reduction in cross-currency swap margins could support the dollar in the near term. Likewise, the impeachment of Donald Trump would likely spark the unwinding of speculative short dollar positions. The euro has indeed retraced earlier gains to less than $1.22.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	11-Jan-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.71 %	+2	+8	-1
EUR Bunds 10y	-0.53%	+7	+10	+4
EUR Bunds 2s10s	18 bp	+6	+3	+4
USD Treasuries 2y	0.13 %	+2	+2	+1
USD Treasuries 10y	1.11 %	+19	+20	+19
USD Treasuries 2s10s	97 bp	+17	+19	+18
GBP Gilt 10y	0.29 %	+9	+3	+9
JPY JGB 10y	0.04 %	+1	+2	+1
€ Sovereign Spreads (10y)	**11-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	20 bp	-3	-5	-3
Italy	107 bp	-9	-13	-5
Spain	56 bp	-6	-8	-5
Inflation Break-evens (10y)	**11-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	90 bp	+5	+26	-
USD TIPS	205 bp	+4	+18	+6
GBP Gilt Index-Linked	301 bp	+1	-22	+1
EUR Credit Indices	**11-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	87 bp	-5	-5	-5
EUR Agencies OAS	38 bp	-3	-5	-3
EUR Securitized - Covered OAS	32 bp	-1	-3	-1
EUR Pan-European High Yield OAS	341 bp	-17	-15	-17
EUR/USD CDS Indices 5y	**11-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	48 bp	+0	-2	+0
iTraxx Crossover	251 bp	+2	-13	+10
CDX IG	50 bp	-2	-4	-1
CDX High Yield	292 bp	-11	-14	-1
Emerging Markets	**11-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	345 bp	-6	-19	-6
Currencies	**11-Jan-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.218	-0.56	+0.59	-0.34
GBP/USD	$1.349	-0.54	+2.03	-1.16
USD/JPY	¥104.15	-0.93	-0.11	-0.82
Commodity Futures	**11-Jan-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$55.0	$4.0	$5.2	$3.3
Gold	$1 842.7	-$94.4	$2.9	-$51.6
Equity Market Indices	**11-Jan-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 825	1.83	4.40	1.83
EuroStoxx 50	3 645	2.60	4.57	2.60
CAC 40	5 707	2.80	3.62	2.80
Nikkei 225	28 139	2.53	5.58	2.53
Shanghai Composite	3 531	0.81	5.51	1.68
VIX - Implied Volatility Index	23.57	-5.23	-7.51	-5.23

Source: Bloomberg, Ostrum Asset Management

Ostrum ASSET MANAGEMENT

Enhancing your power to act

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