

Flash

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What happened?

- Equity markets had one of their strongest days since March on Monday, with the Stoxx50 up 5%, but both US and European markets retreated yesterday, with the S&P500 down 1% and the Stoxx50 down 0.3%. Encouraging news about progress on a vaccine and the German-French Recovery Fund proposal boosted sentiment on Monday, but it faded yesterday as doubts crept up on the early nature of the vaccine trial, and futures are mixed this morning.
- Germany and France put forward a proposal for a EUR500 billion Recovery Fund that would include debt issued by the European Commission (but not “coronabonds”) and grants to the countries hardest hit by the virus. While still a proposal, and with some pushback from Austria and the Netherlands already on grants versus loans, this is a significant step towards more coordination and fiscal integration in Europe, and has a big chance of moving forward in some form since Germany is backing it. Spreads of Italian debt over Germany tightened 25bp on the news.
- Sovereign yields climbed on Monday but have stabilised since, with the 10-year Treasury yield at 0.69% and the 10-year Bund yield at -0.46%. Credit spreads tightened, more in the US than in Europe as the Federal Reserve started buying US IG. US IG is down 15bp, US HY down 45bp, while EU IG tightened 4bp and EU HY 25bp.
- Economic data releases were light. The US NAHB housing index recovered in May, even as housing starts and housing permits dropped sharply in April. The German ZEW index showed an improvement in May as reopening plans shore up confidence, with the expectations component rebounding – the current situation component dropped further. Japanese Q1 GDP dropped “only” 0.9% in Q1 quarter-on-quarter, but given the Japanese economy had already contracted sharply in Q4 2019 following the VAT hike, it is not surprising to have seen some resilience in Q1. However, Q2 will likely be worse, as elsewhere. And Walmart beat earnings expectations.
- Investors remain caught between better virus news and stimulus versus the earnings and economic reality. Sentiment has become more fragile compared to the optimism. Given the strength of the rebound so far, and the fact that expectations for a second leg down is consensus, we may not re-test the lows. Nonetheless, disappointment risk remains and we choose to remain prudent.

What we are watching

- We are looking at reopening plans across different regions, countries and industries, as the recovery cannot just be switched on. We look to see if the number of deaths remain contained with softer confinement measures to see if the path can be smooth. We also look to see if recent encouraging news on treatments materialises.
- We keep an eye on how stimulus is deployed to avoid waves of bankruptcies and defaults, and at how defaults can be ring-fenced if/when they happen. Indeed, it is still too early to tell if these measures will be enough to avoid second-round negative consequences from the outbreak, though the Fed in particular is doing everything in its power – and beyond – to limit these risks.
- We will look closely at earnings estimates as they are revised down. Markets may not be factoring enough adjustment yet, especially as valuations would not look as attractive with a much lower “E”.
- We keep an eye on credit and funding markets to see if massive central bank measures, both in the US and Europe, help ease the recent stress. For now, we believe that central banks will succeed in keeping systemic risks low to prevent a credit crisis.

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