FUNDING YOUR TOMORROW

STRATEGY WEEKLY

Document intended for professional clients

16 March 2020 /// n°11-2020

The invisible enemy

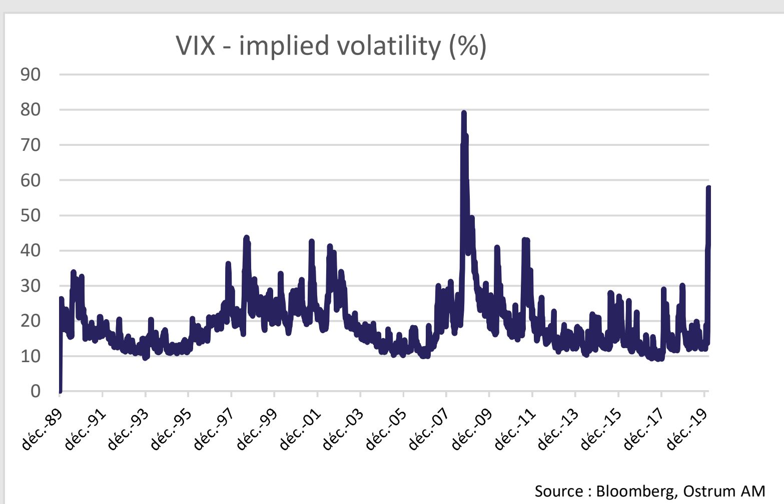
Key Points

- **European stock markets collapse**
- **ECB raises QE purchases, improved TLTRO-III scheme**
- **Fed slashes rates to zero, announces 700b of asset purchases**
- **Yields back up, extreme levels of volatility in credit markets**

Stock markets in Europe collapsed last week. The weekly drop amounts to 20% after a black Thursday. Christine Lagarde's rookie communication mistake sent markets even lower and accelerated sovereign spread widening. Yet the ECB had taken significant measures. Market nervousness is manifesting itself by extreme volatility. The cost of hedging strategies is skyrocketing. Given exceptional market conditions, the Fed slashed rates to zero and resumed QE purchases to the tune of $700b ahead of the FOMC on March 18. The Fed likely reacted to the upturn in long-term bond yields and tensions in USD markets evident in FX swap markets. Bunds (+20bp) no longer hedge losses on peripheral sovereign bonds. Gold (-144$ last week) is no safe haven either.

Risky spreads can only rise due to credit fund outflows on both sides of the Atlantic, especially in high yield space. Credit indices (CDX, iTraxx) continue to trade as a substitute for totally illiquid cash credit bonds. Indeed, iTraxx XO hit high in the vicinity of 600bp, triple 2020 lows. Emerging bond markets is no longer sheltered from global selling pressure.

Chart of the week



The VIX index is at the highest levels since the great financial crisis of 2008. The level of implied volatility was 57% at last week's close.

Unwinding of short positioning on volatility has been concomitant with the rise in stock prices is one of the factors behind the explosion in implied volatility/

Difficulties of risk-parity funds also contributed to the upturn in volatility by selling equities as volatility rises.

A week in hell in markets

The pandemic, which epicenter is now Europe, paralyses the world economy. This a true black swan event, the kind of risk for which there is no precedent to refer too. In Europe, equities lost 20% in five trading sessions. The French CAC 40 plunged 12% on a Black Thursday. Implied volatility on European equities rejoined 2008 levels with VIX highs above 70%. The state of emergency declared in the US, after the European close on Friday did spark a 10% rally in the S&P on Friday only to be undone early on Monday. Weakness in equity markets sent credit spreads higher, especially in high yield markets and later last week across emerging bond markets. The widening in credit spreads was not compensated by a decline in bond yields. The economic risk fosters cash hoarding which in turn contributes to yield curve steepening in both the US and in the euro area. The yield on 10-year notes rose 17bvp last week whilst Bund yields retraced higher by 20bp. Gold plunged fully 144$ last week.

Familiar hedging strategies to mitigate risks have become ineffective. Market liquidity in credit is extremely limited especially if one wants to sell. Banks no longer have the balance sheet to maintain inventory levels consistent with expected trading volumes. In other words, final sellers can only find a bank able to offer a price if that intermediary has identified a final buyer. Investors seeking to cut credit risk exposure are forced to buy protection on credit indices. Hence the spread on iTraxx XO spiked higher by 143bp well beyond 520bp at last week's close. CDS levels are now significantly wider than that on underlying reference corporate bonds.

Deadly absence of global leadership

The pandemic forces a government response comparable to 2008-2009. The coordination of government economic policies is however non-existent in this crisis. Donald Trump's inaccuracies are evidence of a complete lack of leadership of the current US Administration. The G7 will meet early on this week to craft a common message. For the time being, 8b worth of health spending have been announced. Liquidity support and delayed tax payments will be provided to firms facing virus-related difficulties.

Furthermore, European counties have not yet reached common response to the coronavirus and the economic crisis. This has led to multiple government initiatives to fight the crisis. The European commission rechanneled existing funding to a €37b health spending program. Germany announced 12b worth of new investment spending until 2024 and funding for temporary unemployment benefits. Fiscal room for maneuver should be tapped and government guarantees will be expanded. In France, the payment of payroll taxes and other taxes has been postponed and involuntary temporary unemployment will be covered. The fiscal effort is estimated to add to tens of billions of euros. Italy penciled €25b support and the UK inked £30b of additional deficit. In Asia, Beijing unlocked supplementary funding to fight the epidemic. Seoul offered $9b health and youth spending. Japan designed SME support worth $4b.

Central banks' strategies

All the major central banks eased monetary policies since the start of this crisis. The Fed slashed rates to 0-0.25% before market open on Monday and relaunched asset purchases worth $700b. Liquidity demand (totaling 120b) at repo operations on Thursday and Friday likely disappointed the Fed which clearly aims at stabilizing markets. In parallel, the greenback rose last week. The tightening in FX cross-currency swap margins is indicative of excess dollar demand in the rest of the world. US banks may have curtailed USD lending to foreign banking institutions. US dollar provisioning to foreign institutions will go through Fed currency swap lines with other Central Banks (chief among them the ECB).

The ECB held the deposit rate unchanged at -0.50%. A special LTRO maturing in June will help bridge potential liquidity gaps until the next round of TLTRO-III, which terms have been greatly improved. Banks can now borrow up to 50% of their loan book compared with 30% previously at a lower interest rate (-0.75%) than before. Prudential capital ratios have been lowered to raise loanable funds. Furthermore, the ECB added 120b worth of asset purchases until the end of the year to current QE of 20b a month. New bond purchases will be primarily focused on corporate bond markets.

ECB president Christine Lagarde made a rookie mistake during the press conference last Thursday causing dislocation in BTP and OAT markets where futures trading has been suspended. Christine Lagarde had indeed said that the ECB's task was not to narrow sovereign bond spreads. The spread on 10-year Italian BTPs shot up instantly towards 260bp leading all sovereign spreads wider. The yield on French OATs ended last week in positive territory for the first time since January. Now, we must just hope for the best that the targeted measures implemented by the ECB contribute to reverse the very negative investor sentiment.

Main Market Indicators

G4 Government Bonds	16-Mar-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.89 %	+12	-23	-28
EUR Bunds 10y	-0.48%	+38	-8	-29
EUR Bunds 2s10s	41 bp	+26	+15	-1
USD Treasuries 2y	0.37 %	-1	-106	-120
USD Treasuries 10y	0.84 %	+30	-74	-108
USD Treasuries 2s10s	47 bp	+31	+31	+12
GBP Gilt 10y	0.42 %	+26	-21	-41
JPY JGB 10y	0.02 %	+18	+4	+3
€ Sovereign Spreads (10y)	**16-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	61 bp	+13	+36	+30
Italy	256 bp	+28	+123	+96
Spain	130 bp	+18	+61	+65
Inflation Break-evens (10y)	**16-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	24 bp	-14	-58	-
USD TIPS	74 bp	-27	-92	-104
GBP Gilt Index-Linked	283 bp	+1	-26	-28
EUR Credit Indices	**16-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	182 bp	+54	+91	+89
EUR Agencies OAS	72 bp	+16	+31	+28
EUR Securitized - Covered OAS	60 bp	+9	+23	+18
EUR Pan-European High Yield OAS	666 bp	+201	+348	+362
EUR/USD CDS Indices 5y	**16-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	119 bp	+13	+77	+75
iTraxx Crossover	607 bp	+140	+397	+401
CDX IG	119 bp	+7	+75	+74
CDX High Yield	617 bp	+62	+332	+337
Emerging Markets	**16-Mar-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	524 bp	+122	+222	+234
Currencies	**16-Mar-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.113	-2.87	+2.79	-0.85
GBP/USD	$1.231	-6.15	-5.36	-7.16
USD/JPY	¥106.07	-3.68	+3.64	+2.37
Commodity Futures	**16-Mar-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$31.1	-$3.2	-$26.1	-$33.6
Gold	$1 511.9	-$160.9	-$69.3	-$11.0
Equity Market Indices	**16-Mar-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	2 561	-6.77	-24.24	-20.74
EuroStoxx 50	2 492	-15.78	-35.12	-33.46
CAC 40	3 935	-16.41	-35.16	-34.17
Nikkei 225	17 002	-13.69	-28.22	-28.13
Shanghai Composite	2 789	-5.23	-4.38	-8.55
VIX - Implied Volatility Index	73.75	35.42	439.11	435.20

Source: Bloomberg, Ostrum Asset Management

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