Ostrum ASSET MANAGEMENT

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The ECB's permanent easing

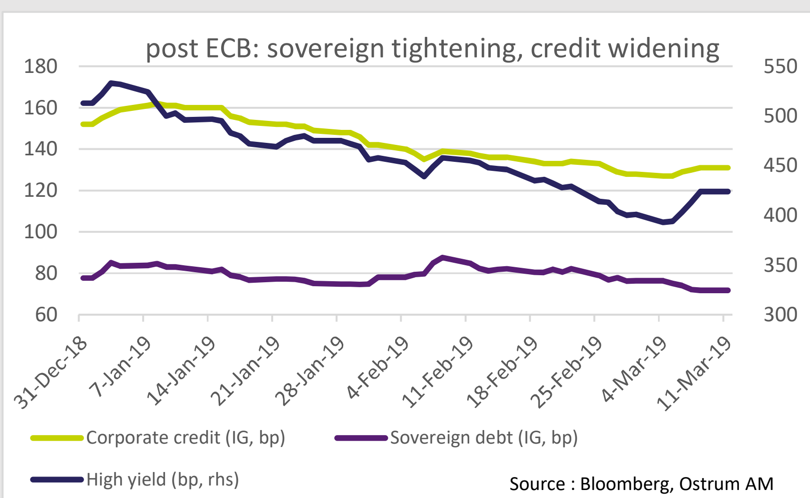
Key Points

- **Draghi cuts forecasts, keeps policy easy**
- **Bund yields under 0.10%, the euro falls further**
- **Euro area: sovereign debt outperforms credit**
- **US equities fell 2% last week as job data disappoints**
- **Brexit: postponement increasingly likely**

The ECB revised down its forecasts and eased monetary policy. Euro area sovereign bonds benefited from the decision, so that bund yields now trade below the 0.10% mark. All sovereign spreads have narrowed. Italian BTPs trade within 250bp vs. Bunds. The impact of ECB easing was less favourable in credit space, in particular on financials. High yield widened noticeably (+23bp) and European stocks fell 1% despite support from a weaker euro. In the US, disappointing February job numbers have amplified the bid for safety. The yield on US 10-year note hovers about 2.65% ahead of the FOMC meeting scheduled next week. Equities have undergone a 2% weekly pullback for the first time this year. The S&P index is still up some 9% in 2019. The dollar strengthened to the detriment of some asset classes including emerging bonds. The retracement of emerging spreads suggest profit-taking was overdue after a strong start of the year amid renewed protectionist threats.

A new round of Brexit-related votes in UK parliament is scheduled this week. This will be more of the same in all likelihood. Uncertainty does benefit Gilts which trade below the 1.20% mark.

Chart of the week



Monetary easing announced by the ECB on Thursday 7 March has had differentiated impacts on asset classes.

After the ECB decision, sovereign spreads (-4bp) have outperformed to the detriment of euro IG credit (+2bp) and, even more so, equities and high yield (+23bp).

Furthermore, financials' bond spreads have widened more than the market overall. In turn, subordinated financials (junior and Tier 1) posted total returns of 1% last week.

Draghi reopens the tap

The ECB took account of the economic slowdown in the euro area that had transpired in a variety of surveys since last autumn. The return to potential growth after a strong year 2017 accelerated late last year due to protectionist measures limiting world trade and political uncertainty. The drop in oil prices (actually quite modest in euro terms) does not compensate for the underlying slowdown dynamics. Inflation may hover about 1.2%ya this year on ECB forecasts before a very slow upturn towards target. Furthermore, the ECB cut its GDP growth forecast from 1.7%ya to just 1.1%ya in 2019. The expected recovery thereafter appears dubious since fiscal policy remains unused in most euro area member countries. It is true that public spending avoided technical recession In Germany but it is by no means a coordinated policy aimed at raising output growth in the longer run. Debt reduction remains Germany's main objective. Instead, euro area countries where public finances are in worse shape, including France and Italy, are the ones pursuing fiscal expansion using inadequate demand policies to tackle supply-side issues. The lack of coordinated government policies remains one of the main impediments to growth in the euro area. On the monetary front, the ECB postponed potential rate increases to 2020, or even later. A new series of targeted LTRO will be launched next September. The ECB had no choice but to prolong long-term refinancing operations as most peripheral banks cannot access market funding at acceptable conditions at present. The maturity of TLTRO-III will be shorter than that of previous long-term loans (2 years instead of 4 years). The maximum amount lent by the ECB will be 30% of the participating bank's loan book. This may create a source of fragility in countries where bank credit hjas continued to shrink despite ECB targeted lending operations. Some Italian or Spanish banks may be unable to roll the total amount of existing ECB loans in this context.

FOMC to clarify balance sheet policy next week

Activity in the US is still stronger than in the rest of the world. Yet, retail sales disappointed over the December-January period and employment rose only 20k in February. That prompted some (over-)reaction form market participants although growth is still likely to come in above potential of 1.7% on Fed estimates even as the economy operates at full employment. In any case, the Fed is very unlikely to roll back the dovish language. Priority for Fed policymakers is to set a timetable for the expected end of balance sheet shrinkage. The recent change of tone by the Fed played a key role in propping up asset prices. Jerome Powell will take no risk to reignite an equity correction all the more so that potential dollar appreciation would be detrimental to the US trade balance, which already show an outsized deficit.

In the UK, Gilts remain a function of political shenanigans around the Brexit process. A new round of votes is scheduled with much the same issues on the table: deal/no-deal, procrastination and postponement of effective Brexit date.

Neutrality on rates

In terms of strategy, the major bond markets exhibit the same bullish backdrop. The decline in bond yields continues in the wake of ECB easing. Bund yields trade within 0.10% helping to lower spreads across the board in both core and non-core sovereign markets. The spread on French OATs indeed came in within 40bp. Recent success at Spanish bond syndication is a sign of great investor interest for long-dated sovereign securities. Spain's Bonos indeed trade within 110bp. Besides Mario Draghi's dovish turn, the possibility of early elections and somewhat reassuring survey data ignited a bout of optimism in Italian bond markets. We are still cautious on Italian bonds and prefer holding other peripheral bonds. In the US, the Fed's change of heart maintains 10-year yields way under their fair value of 3.10% at present. At 2.65%, US bond yields are near the upper end of their forecasted range for year-end print (2-2.75%) assuming no more hikes and ending of balance-sheet run-off.

In equity space, the dollar's rise proved detrimental to US indices. It is also likely that a number of investors chose to take profits after double-digit returns year-to-date. The widespread rally in stocks provides a favourable backdrop for profit-taking. Utilities and telecommunication services have been safe havens whilst cyclical stocks took a beating. The energy sector sector lost fully 4% last week. In Europe, the drop was cushioned by the euro's depreciation under $1.13 as ECB pushed out rate hikes. Banks suffer from less favourable terms for the new TLTRO-III series whilst cyclicals (automobiles and basic resources) resume outperforming. The move into utilities was also quite pronounced in European markets.

Euro Investment grade bond markets, pulled down by financials, did underperform sovereign bond indices in the past week. The average spread on the asset class increased by 3bp. Flows also reversed in European high yield and emerging bond markets where spreads had shrunk considerably since the start of the year. It also hints at profit-taking considering outsized capital gains so far this year. Speculative-grade corporate bond spreads widened by as much as 23bp in five trading sessions. The average spread in emerging markets (USD global diversified) is up some 20bp from a week ago to 357bp.

Main Market Indicators

G4 Government Bonds	11-Mar-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.54 %	-3	+3	+7
EUR Bunds 10y	0.06%	-10	-6	-18
EUR Bunds 2s10s	60 bp	-7	-9	-25
USD Treasuries 2y	2.47 %	-7	-1	-1
USD Treasuries 10y	2.64 %	-8	-1	-4
USD Treasuries 2s10s	17 bp	-1	0	-3
GBP Gilt 10y	1.17 %	-11	-1	-11
JPY JGB 10y	-0.03 %	-4	0	-4
€ Sovereign Spreads (10y)	**11-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	34 bp	-6	-10	-13
Italy	250 bp	-8	-28	0
Spain	109 bp	+8	-3	-8
Inflation Break-evens (10y)	**11-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	96 bp	-3	+5	-4
USD TIPS	191 bp	-3	+9	+20
GBP Gilt Index-Linked	315 bp	+7	-3	-2
EUR Credit Indices	**11-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	131 bp	+3	-8	-21
EUR Agencies OAS	55 bp	-2	-7	-5
EUR Securitized - Covered OAS	53 bp	-3	-9	-10
EUR Pan-European High Yield OAS	424 bp	+23	-34	-89
EUR/USD CDS Indices 5y	**11-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	63 bp	+1	-10	-26
iTraxx Crossover	285 bp	+7	-31	-69
CDX IG	62 bp	+1	-6	-26
CDX High Yield	356 bp	+8	-7	-94
Emerging Markets	**11-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	357 bp	+20	-3	-58
Currencies	**11-Mar-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.123	-0.89	-0.35	-1.93
GBP/USD	$1.310	-0.63	+1.93	+2.77
USD/JPY	¥111.24	+0.43	-0.71	-1.42
Commodity Futures	**11-Mar-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$66.6	$0.9	$5.0	$12.3
Gold	$1 292.3	$5.7	-$15.1	$10.8
Equity Market Indices	**11-Mar-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 775	-0.63	2.42	10.71
EuroStoxx 50	3 306	-0.34	4.43	10.14
CAC 40	5 268	-0.36	5.05	11.35
Nikkei 225	21 125	-3.19	1.25	5.55
Shanghai Composite	3 027	-0.02	13.29	21.38
VIX - Implied Volatility Index	14.63	0.00	-8.39	-42.45

Source: Bloomberg, Ostrum Asset Management

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