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ECB TLTRO-III tops €1.3T

Key Points

- **US: encouraging signs of recovery**
- **TLTRO-III: ECB will lend €1.3T**
- **Dollar firms up**
- **Fed starts purchases of single-name corporate bonds**

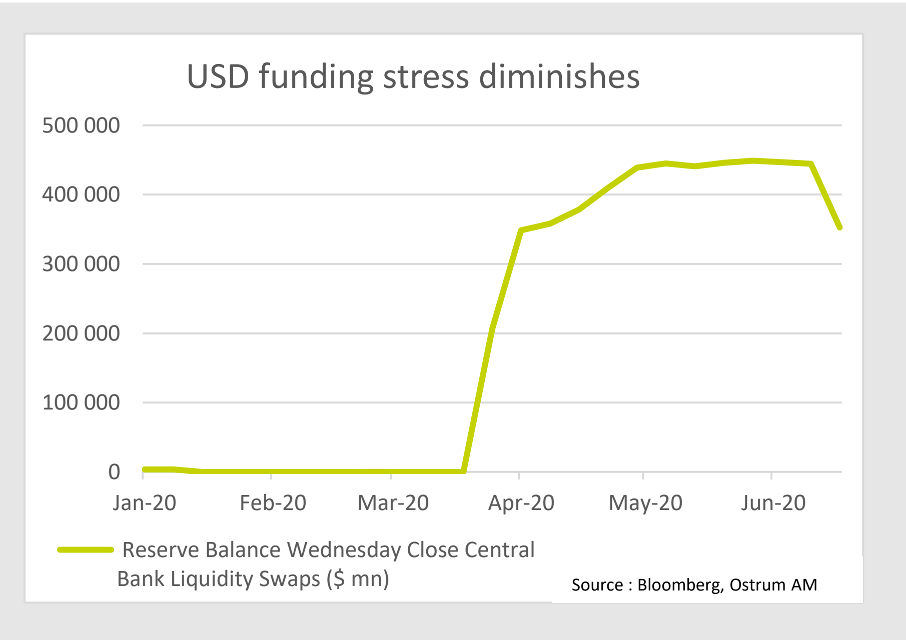
Last week turned out to be positive for risk assets despite some profit taking on quadruple-witching Friday in the US. The S&P 500 closed on a 1.8% weekly gain whilst European indices were up 3%. The decline in the euro below $1.12 surely benefitted European stocks. The Fed, confronted with lower foreign demand for Treasuries, must now support the dollar.

The yield on 10-year notes oscillates about 0.70% in the US and around -0.40% on Bunds. Sovereign bond spreads eased further. In parallel, breakeven inflation rates widened by 9bp on 10-year TIPS.

US credit tightened by 13bp. The Fed has defined its benchmark allocation for single-name corporate bonds. In Europe, corporate debt also outperformed risk-free bonds.

High yield bonds shrank despite Moody's' warning that defaults will creep higher in the second half. US high yield spreads decreased by 33bp last week to 515bp vs. US Treasuries.

Chart of the week



The market drawdown in March revealed a dearth of dollars in the world. The Fed intervened by lending as much as $450b to major Central Banks able to lend to financial institutions in their jurisdictions in demand for USD funding.

The amount of swap lines declined last week for the first time since the outbreak of the crisis. European and Japanese banks have now reduced their dollar funding exposure. Liquidity operations will be less frequent from now on, which should be supportive for the US dollar going forward.

Economy takes a breather as confinement measures are pared

Economic data releases now seem to reflect the benefit of the gradual easing of lockdown measures on activity. Manufacturing surveys (Empire, PhilFed) picked up noticeably in June. The bounce in retail spending was faster than anticipated. Household consumption expanded at a 17.7%m clip in May after a 14.7%m plunge in the previous month. The upturn in auto sales from the April low is quite significant. Residential construction is also stronger than expected. Homebuilders' confidence is back above the key 50 breakeven line. Building permits improved last month, which hints at a pickup in housing starts over the months ahead. Mortgage credit demand is indeed solid. However, industrial output which posted a modest advance in May will likely increase to match stronger spending after inventory liquidation is complete.

Fed allows stronger dollar

The dollar appreciated last week without a concomitant bout of risk aversion. The euro fell back below 1.12$. The amount lent by the Fed via the Central bank swap lines shrank by about $100b last week. European and Japanese banks indeed adjusted dollar funding demand lower. Excess demand for the greenback observed at the height of the financial stress in March has waned allowing the Fed to pare its provision of dollars to the rest of the world. Swap operations will be less frequent in the weeks ahead, which should provide marginal support to the dollar.

Furthermore, Treasury International Capital data (TIC) reported heavy selling of US treasuries totaling $475b in March-April on the part of foreign institutions (both official and private). The Fed responded by expanding asset purchases to make up for the shortfall in foreign demand for US Treasuries and supplied dollars to stem bond selling. The current situation is uncomfortable for the Fed hence its hesitation of policymakers to engage in yield curve control whilst Congress works on another stimulus program of $1T+ (HEROES Act).

T-note yields stable about 0.70%

US bond markets traded sideways since the last FOMC communiqué which indicated that Treasury bond purchases will hover about €80b a month. With no curve movement last week, the trend is still for a steeper curve considering the impact of increased federal deficit and lengthening of bond duration sold to the public. Dollar stabilization did not prevent a widening in breakeven inflation rates. Inflation is likely to be materially higher than current levels implied by TIPS markets (129bp). As concerns MBS, the Fed will purchase $40b worth of securities per month, which should be enough to absorb expected net issuance. Spreads nevertheless remain elevated given large refinancing activity.

TLTRO-III loans total €1.3T

In the euro area, the new 10-year Bund benchmark bond is trading below -0.40%. Despite the latest fiscal stimulus package requiring 62b additional funding this year, the German yield curve flattened further. Asset swap spread levels remain rather tight about 30bp on Bunds. The yield on 30-year Bunds is slightly positive. Sovereign spreads remain in high demand after the June TLTRO-III. The loan operation drew demand worth $1.3T in gross terms. Maturing operations will reduce the net liquidity add-on to €549b. The TLTRO loans comes on top of the 600b added recently to the PEPP. Banks will use cheap funding (-1% interest in the first year) to fund carry trades in sovereign bond markets. Spreads on Italian, Spanish and Portuguese 10-year sovereign debt securities narrowed further by 5-10bp last week.

Credit markets remain well oriented. In the US, the Fed now purchases single-name corporate bonds after initial interventions across credit ETF markets. Like the ECB, the Fed has defined a target benchmark allocation with constraints including a maximum residual maturity of 5 years. US investment grade bon spreads tightened by 13bp last week to 143bp vs. US Treasuries. High yield profited from the buoyant credit markets although Moody's forecasts point to a sharp acceleration in defaults in the months ahead. Default rates could fetch 12% in 2020. High yield offers premiums to the tune of 578bp at present.

In euro-denominated bond markets, high-grade corporate credit is still in high demand. Underperformance of the financial sector so far in June diminished slightly last week as the ECB's 4th TLTRO-III drew considerable interests from euro area banks. Furthermore, low new issue premiums hint at strong institutional demand and ECB buying pression. In turn, Moody's forecasts point to 6% default by year-end, which seems too high. In fact, high yield fun inflows remain quite supportive of the asset class.

Main Market Indicators

G4 Government Bonds	22-Jun-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.69 %	-4	-1	-9
EUR Bunds 10y	-0.45%	-1	+3	-27
EUR Bunds 2s10s	24 bp	+3	+5	-18
USD Treasuries 2y	0.18 %	-1	+1	-139
USD Treasuries 10y	0.68 %	-4	+2	-124
USD Treasuries 2s10s	50 bp	-3	+1	+15
GBP Gilt 10y	0.19 %	-1	+2	-63
JPY JGB 10y	0.01 %	+0	+1	+2
€ Sovereign Spreads (10y)	**22-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	33 bp	-8	-13	+2
Italy	174 bp	-16	-34	+14
Spain	91 bp	-10	-21	+25
Inflation Break-evens (10y)	**22-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	48 bp	+4	+16	-
USD TIPS	129 bp	+6	+18	-50
GBP Gilt Index-Linked	287 bp	+3	-1	-25
EUR Credit Indices	**22-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	143 bp	-3	-51	+50
EUR Agencies OAS	54 bp	-3	-14	+10
EUR Securitized - Covered OAS	42 bp	-3	-13	+1
EUR Pan-European High Yield OAS	519 bp	-14	-135	+215
EUR/USD CDS Indices 5y	**22-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	68 bp	-2	-12	+24
iTraxx Crossover	394 bp	-8	-86	+188
CDX IG	78 bp	-2	-10	+32
CDX High Yield	501 bp	0	-123	+221
Emerging Markets	**22-Jun-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	470 bp	-12	-79	+179
Currencies	**22-Jun-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.124	-0.37	+3.14	+0.12
GBP/USD	$1.242	-1.13	+2.05	-6.34
USD/JPY	¥106.82	+0.39	+0.77	+1.65
Commodity Futures	**22-Jun-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$42.2	$2.5	$6.5	-$20.7
Gold	$1 760.5	$39.2	$25.9	$237.7
Equity Market Indices	**22-Jun-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 080	0.45	4.23	-4.66
EuroStoxx 50	3 228	2.93	11.11	-13.80
CAC 40	4 929	2.36	10.91	-17.54
Nikkei 225	22 437	4.21	10.05	-5.15
Shanghai Composite	2 965	2.60	5.38	-2.78
VIX - Implied Volatility Index	34.71	0.90	23.26	151.89

Source: Bloomberg, Ostrum Asset Management

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