Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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Markets hit by virus resurgence

Key Points

- **The sanitary crisis worsens in the US**
- **Biden ahead in election polls**
- **Equity selling accelerates towards semester-end**
- **T-note rallies, high yield underperforms**

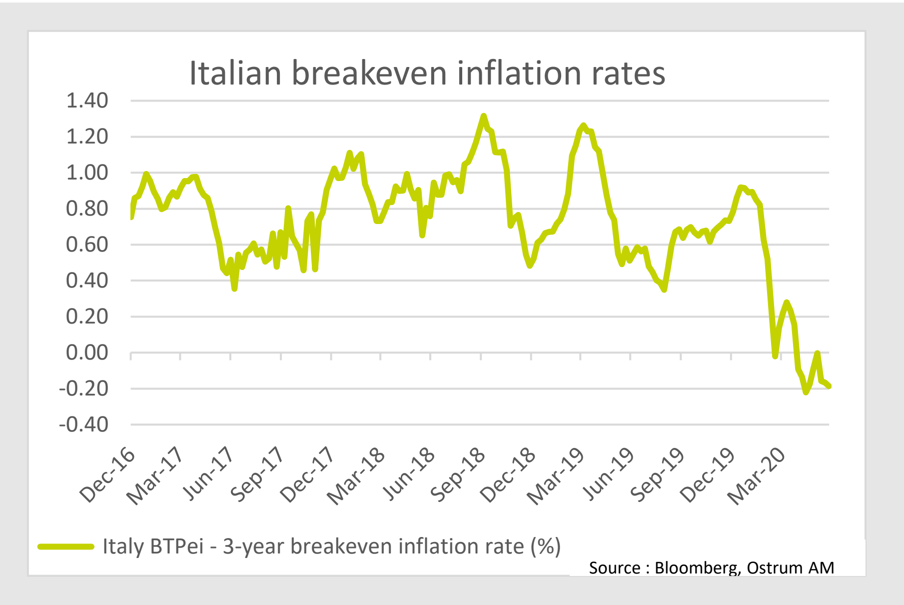
The epidemic does not appear to be under control in the US, in particular in southern states. Health concerns took center stage in markets even as economic surveys rebounded and US equity indices lost 2% last week.

Europe was relatively spared but, as the semester draws to an end, profit taking occurred. The same is true in credit. Final investor flows slowed on both sides of Atlantic whilst primary market activity remain sustained as spreads oscillate about 145bp. High yield indices widened by 39bp last week in the US and 16bp in iTraxx XO (407bp).

In bond markets, T-notes benefitted from risk aversion. Ten-year yields are trading about 0.65%. The rally in nominal bonds did not prevent a rise in inflation breakevens. In the euro area, Bund yields dropped to -0.50% and swap spreads widened. Sovereign spreads moved little thanks to ECB support and a solid bullish consensus on peripheral bonds after the TLTRO-III operation.

The dollar strengthened after new US protectionist measures against Europe. The yen depreciated to 107.5 against the greenback leaving gold as the only real safe haven. The euro nevertheless resisted at $1.126.

Chart of the week



Inflation breakevens reflect market expectations for consumer price changes. Most European index-linked bonds are linked to euro area inflation ex-tobacco.

And current breakeven inflation levels (-0.20% on 3-year BTPei) remain inconsistent with observed inertia in underlying inflation (close to 1% per annum). Credit risk and liquidity affect security pricing (by reducing breakeven inflation rates regardless of inflation expectations). BTPei hence price in an attractive risk premium.

US economic recovery jeopardized by resurgence in virus

The latest observations indicate a significant upturn in new Covid cases in the US. Total new cases of Covid-19 as back the previous epidemic crisis in April. Significant deterioration can be seen across the country in the southern part of the country from Arizona, to Texas and Florida. This may require new measures to address the sanitary crisis. The health situation will be an important factor in the upcoming presidential election. Joe Biden leads in polls by a considerable margin (by as much as 12 points) and current polls indicate a landslide win for the Democrats. Chances of a Democratic senate have also risen.

The Covid-19 epidemic took a turn for the worse amid encouraging signs of recovery since the April economic collapse. Indeed, 2q20 GDP growth will show historic contraction in activity. Activity may have declined by 45% at annual rate in the three months to June but regional manufacturing surveys surprised on the upside in June. Residential investment appears to be holding up thanks to Fed support. Household consumption, the main demand growth driver, picked up in May (+8.1%m) but fell short to making up for the 12.2%m decline in April. That said, weekly initial jobless claims remain elevated at around 1.5mn and current job losses appear more likely to be made permanent. Indeed, mass layoffs plans are ten times as large as the pre-crisis norm. Corporations have to restructure and adapt to the new economic backdrop. Federal income support worth $600 per week may thus be prolonged beyond July. A new $1T fiscal stimulus program may soon be launched.

Gauging quarterly portfolio rebalancing

As concerns financial markets, the end of the first semester is usually a time to reshuffle portfolios. Pension funds in the US and Japan may reduce exposure to equities by some $95b in total according to JPM estimates. Sovereign funds and balanced funds may use the recovery in equity markets to rebalance portfolios into bonds. Last week declines in equity indices may indeed hint at greater caution on risky assets on the part of institutional investors.

Underperformance of quality and the concomitant rebound in deep-value cyclicals may be coming to an an end. Valuation levels appear worrisome ahead of a challenging quarterly earnings season. In the US, EPS forecasts for the S&P 500 companies suggest a 9% drop this quarter. The expected pick-up in the second half of the year appears optimistic in light of the prevailing sanitary risks and likely reflect enhanced leverage effect. Current valuations leave little room for disappointment. High valuations may actually be the chief reason behind persistent volatility. This market backdrop should be a boon for quality stocks with high earnings visibility. In the financial sector, Fed stress tests reveal that losses could fetch $700b under the most adverse economic scenario for the 34 banks reviewed. Given risks to financial stability, the Fed will limit dividend payouts and ban buybacks in the 3Q20. Total yield to shareholders has increased to a whopping 15% of S&P500 banks' market capitalization in the first quarter.

In the euro area, equity indices dropped roughly 1% last week. The fall was broad-based amid low volumes. Transport and leisure activities posted 5% declines while basic resources lost about 4%. The earnings season is looming. Earnings are expected to post a 23% decline in 2020. Hence, valuations appear somewhat stretched at 16x.

Yields drift lower

In bond markets, the worrying acceleration in positive cases in the US entailed support to safe government debt. The yield on 10-year notes trades below 0.65%. Flight to safety sparked US yield curve flattening. The upcoming data releases could add fuel to the flattening trend despite the improvement in June surveys. The release of FOMC minutes may shed some light on the prospects for yield targeting by the Federal Reserve.

In the euro area, Bund yields have drifted towards -0.50% in the wake of ECB liquidity injections (TLTRO-III and PELTRO). Swap spreads have widened by 5-6bp in the past week. High demand at PELTRO operations (€15.6b) may be a sign that smaller banks have already borrowed the maximum TLTRO amount. Liquidity may be used to fund carry trades on short-dated sovereign bonds. Perception of sovereign credit risk has improved but there are still sizeable risk and liquidity premiums embedded in BTP pricing. Peripheral sovereigns still offer tightening potential.

Credit is taking a breather due to heavy primary market activity and a slowdown in final investor buying flows. The reduction in new issue premiums suggest that institutional demand has not vanished. Current spreads have erased March stress but still remain near 2015-2016 and autumn 2018 wides.

Main Market Indicators

Emprunts d'Etats	29-juin-20	-1sem (pb)	-1m(pb)	2020 (pb)
EUR Bunds 2a	-0.69 %	-1	-3	-9
EUR Bunds 10a	-0.48%	-4	-3	-29
EUR Bunds 2s10s	22 bp	-3	+1	-20
USD Treasuries 2a	0.16 %	-4	0	-141
USD Treasuries 10a	0.63 %	-7	-2	-128
USD Treasuries 2s10s	48 bp	-4	-1	+13
GBP Gilt 10a	0.16 %	-3	-3	-66
JPY JGB 10a	0.02 %	+1	+1	+3
EUR Spreads Souverains (10a)	**29-juin-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
France	35 bp	+3	-2	+4
Italie	177 bp	+4	-15	+17
Espagne	94 bp	+4	-7	+29
Inflation Points-morts (10a)	**29-juin-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
EUR OATi (9a)	51 bp	+3	+10	-
USD TIPS	132 bp	-1	+18	-46
GBP Gilt Indexés	288 bp	-1	-4	-23
EUR Indices Crédit	**29-juin-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
EUR Credit IG OAS	149 bp	+6	-29	+56
EUR Agences OAS	57 bp	+3	-6	+13
EUR Obligations sécurisées OAS	44 bp	+2	-6	+3
EUR High Yield Pan-européen OAS	532 bp	+13	-85	+228
EUR/USD Indices CDS 5a	**29-juin-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
iTraxx IG	71 bp	+4	-2	+27
iTraxx Crossover	398 bp	+8	-30	+192
CDX IG	80 bp	+3	-1	+35
CDX High Yield	537 bp	+40	-30	+257
Marchés émergents	**29-juin-20**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
USD JPM EMBI Global Div. Spread	475 bp	+6	-44	+185
Devises	**29-juin-20**	**-1sem (%)**	**-1m(%)**	**2020 (%)**
EUR/USD	$1.125	-0.17	+1.27	+0.12
GBP/USD	$1.227	-1.56	-0.59	-7.49
USD/JPY	¥107.69	-0.76	+0.13	+0.83
Matières Premières	**29-juin-20**	**-1sem ($)**	**-1m($)**	**2020 ($)**
Brent	$41.3	-$1.7	$3.5	-$21.6
Or	$1 771.1	$16.1	$40.9	$248.3
Indices Actions	**29-juin-20**	**-1sem (%)**	**-1m(%)**	**2020 (%)**
S&P 500	3 041	-2.63	-0.28	-6.04
EuroStoxx 50	3 240	-0.24	6.02	-13.65
CAC 40	4 951	0.05	5.44	-17.18
Nikkei 225	21 995	-1.97	0.54	-7.02
Shanghai Composite	2 962	0.76	5.09	-2.91
VIX - Volatilité implicite	33.79	6.36	22.83	145.21

Source: Bloomberg, Ostrum Asset Management

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