MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 007 // **25 January 2021**

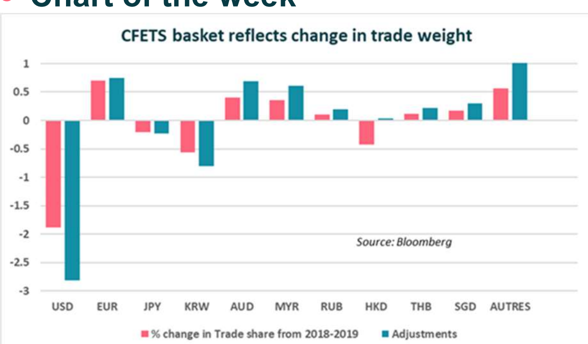
Topic of the week: Europe: japanification?

- **The similarities between Europe and Japan are indisputable, and worrying: ageing of the population, zero rates, etc.**
- **There are also important differences which make it possible to hope that Europe is not caught up in a deflationary spiral. The main difference is the strength and speed of monetary policy response.**
- **The main point then is perhaps the fact that doubt remains. The efforts made have put the area on a different trajectory than that of Japan. But the battle is far from won.**

Market review: Italian worries

- **ECB signals symmetry in asset purchases**
- **Fed to hold policy unchanged this week**
- **Italian spreads higher on political woes**
- **Technology, stay-at-home stocks advanced sharply last week**

Chart of the week



On January 1st, China adjusted its benchmark basket of currencies, the CFETS. The adjustments are proportional to commercial trade.

The weight of the dollar is down while that of Asian currencies is up. This reflects China's focus towards Asia Pacific by increasing its trade, to the detriment of the United States because of the trade war.

This also means that the Chinese exchange policy will be less dependent on the dollar. The trend is therefore to an appreciation of the yuan.

Figure of the week

25

Source : Ostrum AM

The number of executive orders signed by Biden on day one of his presidency. It took almost 100 days for Trump to reach that mark. Both Obama and W. Bush were still far from it after 100 days.

Stéphane Déo
Head of markets strategy

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● **Topic of the week**

Europe: japanification?

There are undoubtedly similarities between the current situation in Europe and that in Japan: ageing of the population, zero rates, etc. There are also important differences which make it possible to hope that Europe is not caught up in a deflationary spiral. The main difference is the strength and speed of monetary policy response. The treatment provided to the patient is different, which helps to maintain hope, even if it does not necessarily mean that the end result will be different.

"A Cause for Pride: In 2015, the launch of EQ prevented deflation."

- Benoit Coeuré – interview at Libération, December 16, 2019

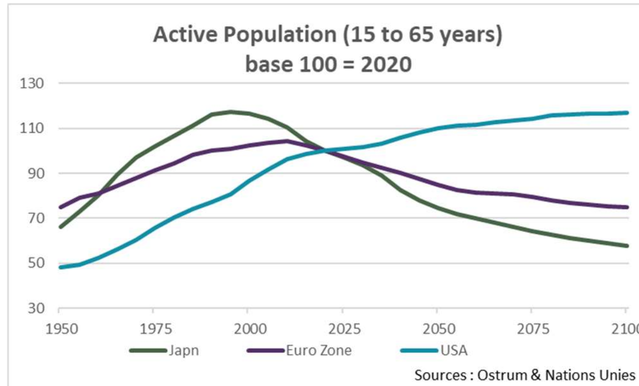
The term "japanification" covers the idea that Europe, or at least the Eurozone, is on the same trajectory as Japan. But because the term is poorly defined, each commentator has its own definition … and therefore its own conclusion. So here we're looking at the different aspects of "japanification".

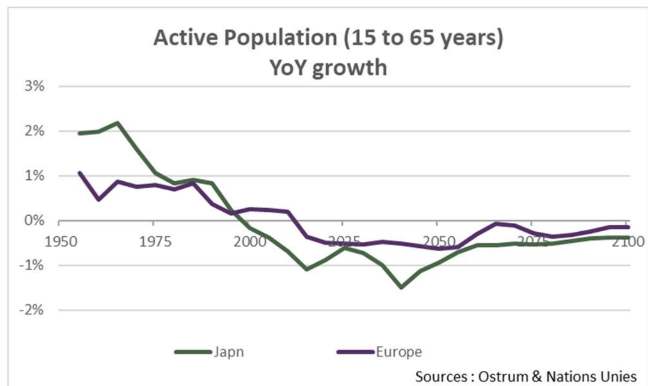
One of the major differences between Japan and the eurozone is the starting point; the Japanese crisis stems from the bursting of a housing bubble of an inconceivable and unprecedented scale. This type of crisis is different in the sense that real estate is a widely distributed collateral, at least more widely than equities. When real estate collapses, it has a lasting impact on the solvency of borrowers and credit banks in a country that is otherwise very closed to foreign financial institutions. Some countries have experienced the bursting of their housing bubbles but this has not become widespread throughout the euro area.

Demography

Let's start with a long, even very long, term view: demography. With a fertility rate well below 2.1, the European population is expected to decline. Economists are more concerned about the working-age population. The graph below shows that Europe is doing well following of Japan. It has a declining labour force since the mid-1990s, just after the boom in the speculative bubble. Europe, on the other hand, began its decline in the second half of the previous decade.

It should be noted, however, that the magnitude of this decline is different; between 2020 and the middle of the century, the Japanese working population is expected to fall by 26%, or 1.0% per year, while in the Eurozone the decline is 15%, or 0.5% per year on average. The Japanese labour force would then dip from 74.7 million in 2020 to 55.6 million in 2050, and that of Europe from 48.1 million to 40.9 million.





It should also be noted, however, that adverse demographics are not inevitable. There are three ways around the problem:

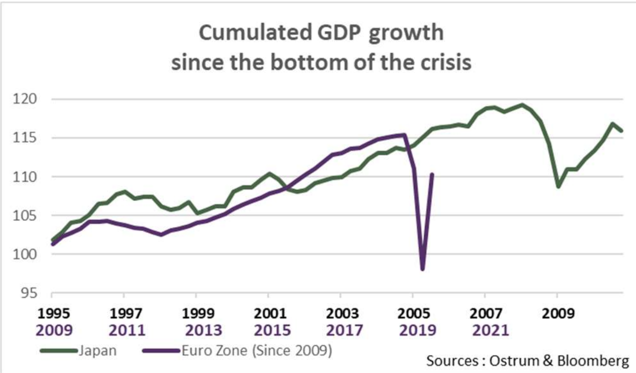
- Importing work, this is called immigration. Which is almost non-existent in Japan.
- Increase the participation rate.
- Increase productivity. See next chapter on growth.

Conclusion: although the demographic trend is very similar, it should be kept in mind that the extent of the reduction of the working population is less in the Euro Area than in Japan.

Japanification score : 4/5

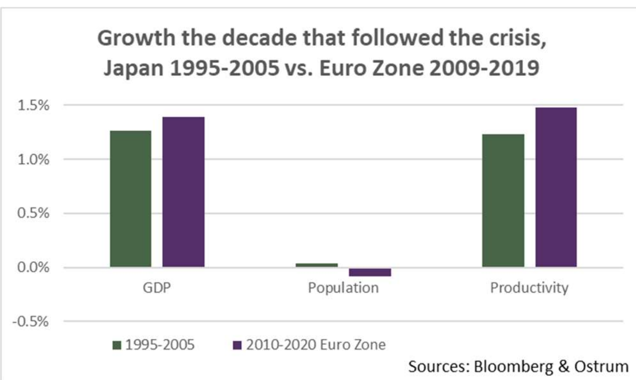
Growth

The chart below tells us that European economic growth has recovered at the same rate as Japanese growth. The year of recession in Japan was 1993 and the country recorded a cumulative growth of 14.4% over the ensuing decade. The Eurozone hit a low in the first quarter of 2009 and gained 15.1% over the same period. At an annual rate, the Euro Area makes 1.4% against 1.3% in Japan, a totally negligible difference.



Moreover, the similarity of economic performance is maintained in terms of productivity. The change in the labour force in Japan over the decade after the crisis was 0.0% on average per year compared to -0.1% in the euro area. As a result, GDP per capita growth is somewhat more favourable in the case of the Eurozone, but this remains within very low margins.

In summary, the two trajectories are very similar.

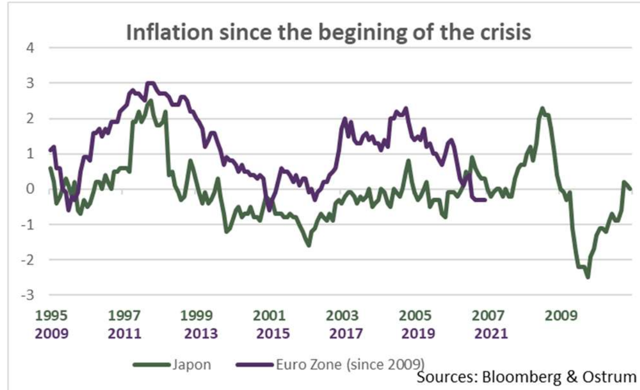


Conclusion: no significant difference between Japan's growth trajectory over the decade following the crisis and that of the Eurozone.

Japanification score : 5/5 

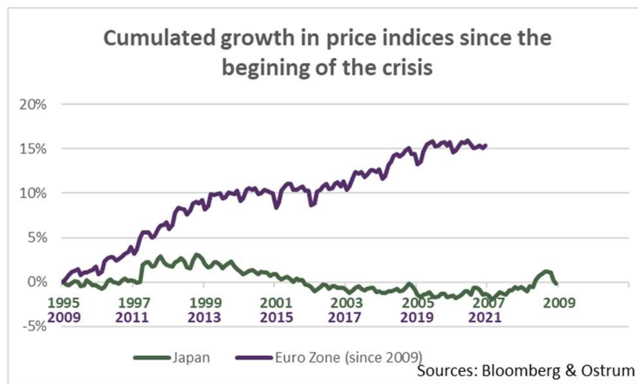
Deflation

One of the main features of "Japonisation" is deflation. The chart below shows that inflation remained very low after 1995. Over the next ten years, the average was -0.1%. By contrast, while European inflation has been low, it has never been permanently negative. Since 2009, euro area inflation has averaged 1.1% at an annual rate. Although this figure is low, below the ECB's 2% target, the trend is dissimilar from that of Japan.

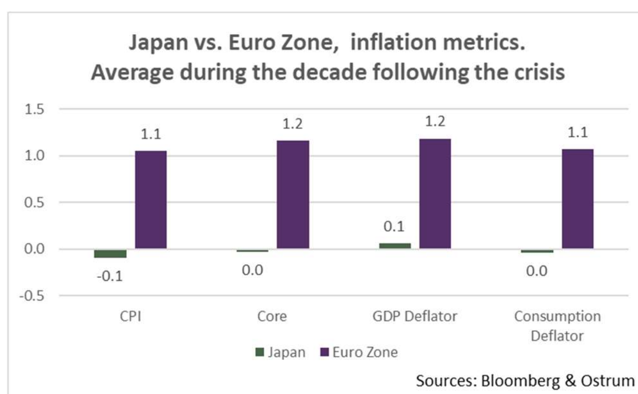


If we turn our attention to the cumulative growth of the price index, the divergence between the two indices is even more marked.

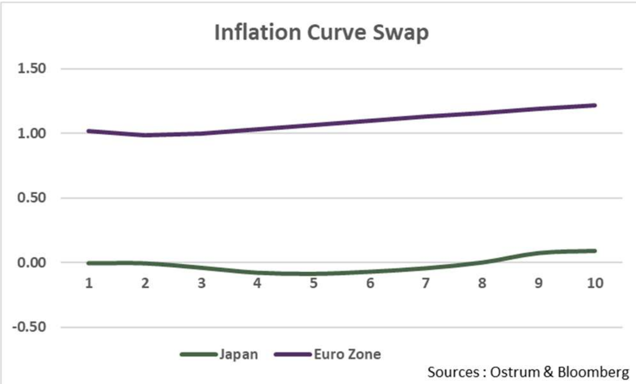
Other measures of inflation may also be of interest. In particular, core inflation, which excludes food and energy prices, or the GDP deflator and consumption deflator.



The message remains the same: Japan is in deflation, with a very slow fall in prices, while the progression of the indices of the Euro area is of the order of 1.0 to 1.5% over the period. Once again, euro area inflation is low, below the ECB target, but remains above zero. Deflation did not materialise in the Eurozone.



What about inflation expectations? As far as the market is concerned, there are unfortunately no series in Japan, with dates spanning back to the decade following the crisis.



On the other hand, a current photo also shows a very strong divergence Japan/Eurozone. Japanese expectations are very stable and close to 0% over the next ten years, the market does not believe at all in an exit from deflation. The case of the Eurozone is not very comfortable, but the curve is above 1%. Once again, this is below ECB's objective, but the market is keeping inflation normalization as the central scenario, albeit very slowly.

The argument is important, one of the main causes of the persistence of deflation is the low level of expectations that creates an anchor. The fact that these expectations remain at a decent level therefore constitutes a fundamental difference between the Japanese and European situation.

Conclusion: on one of the fundamental elements of Japonisation, the persistent deflation, the Eurozone stands out very clearly. While the risk of deflation cannot be ruled out, inflation has remained far from zero.

Japanification score : 2/5

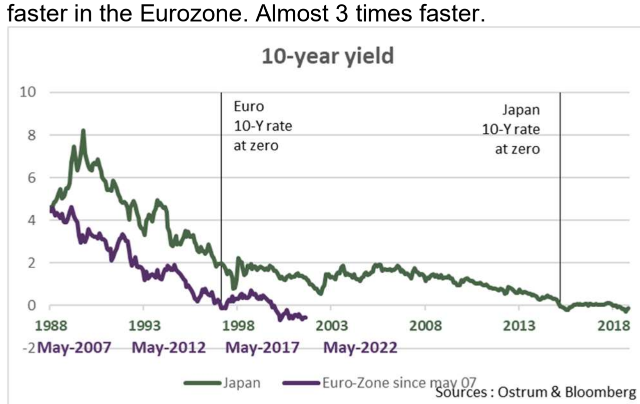
Monetary policy

If there is one important difference between the Japanese experience and the Eurozone, it is the speed and scale of the monetary policy response. The BoJ has been criticized for reacting too timidly and too late to the problem.

Has the ECB done better? The difference, judging by the evolution of the rates, is marked. To do this we take as the starting date of the crisis the peak on the equity market, December 1989 in the case of Japan, May 2007 in the case of the Euro Area.
The first graph below shows the evolution of short rates. The famous "ZIRP" for "Zero Interest Rate Policy" was introduced in Japan in April 1999, 9 years and 4 months after the market peak. The ECB was faster by 2 years. The difference is noticeable but maybe not that substantial.

However, the difference is more substantial on the transition to negative yields: 7 years and 4 months after the start of the crisis in Europe, while the three-month Japanese rate is still not there, after 20 years. The difference is important because while the BoJ has implemented a zero-rate policy, it has always communicated on the idea of a future normalization. Rate expectations show that the aggressiveness of the message is below that of the ECB.

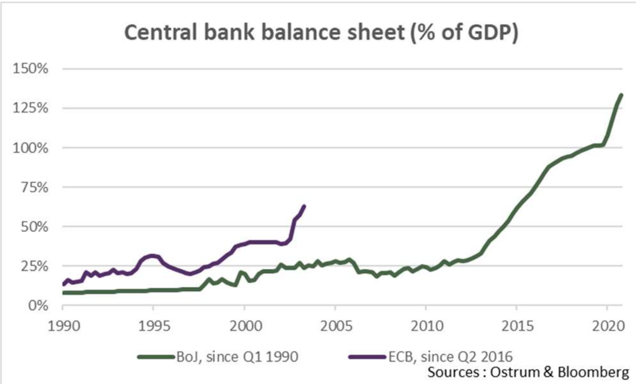
Long rates, we use the 10-years tenor, also plunged much faster in the Eurozone. Almost 3 times faster.



In summary, the ECB was more aggressive and faster than the BoJ. The table below summarizes the evolution.

	Euro Zone	Japan	Lag ratio
Peak of the equity market	May-2007	Dec-1989	
3-M rate below 0,1%	Sep-2014	Apr-1999	
lag from eq market peak	7 Year and 4 Months	9 Year and 4 Months	1.3
3-M rate negative	Sep-2014	Not Yet	
lag from eq market peak	7 Year and 4 Months		+∞
10-Y yield reaches zero	Jun-2016	Feb-2016	
lag from eq market peak	9 Year and 1 Months	26 Year and 2 Months	2.9

To be complete, of course, QE must also be mentioned. The BoJ's balance sheet currently represents 133% of the country's GDP compared to 63% in the case of the ECB. But here too, the ECB reacted faster than the BoJ, at the same point in the cycle, the BoJ had a balance sheet of about 25% of GDP and it took more than a decade to reach the level where the ECB is currently.



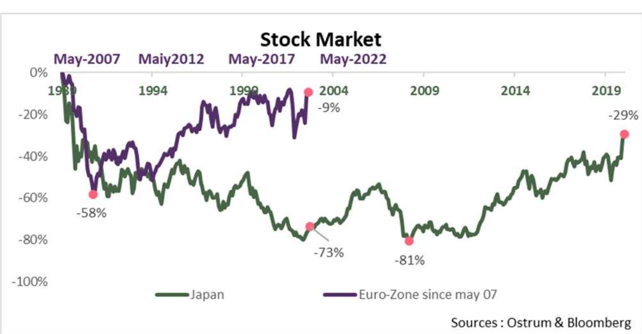
Conclusion: whether in terms of rate level or EQ, the ECB reacted faster and more aggressively than the BoJ. The lessons from "too little too late" was retained and the reaction function was therefore modified. Does this mean that the ECB will lead the Eurozone economy out of Japanization? Nothing is less certain: the treatment given to the patient is different, it does not necessarily mean that the result will be different.

Japanification score : 1/5

Stock market

Last point on the financial markets, the performance of equities. The chart below shows that since its May 2007 high, the Euro Stoxx is still 9% lower, so it has not quite corrected the 58% decline recorded in two years. Over the same time frame, the Nikkei not only was still 73% lower than at its peak, but had not yet hit its lowest which would be reached 5 and a half years later.

There is therefore a major difference between the market performance of the two zones. Although the Euro Stoxx has not fully recovered (it should be noted that by taking into account dividends payments, the performance since the 2007 highs is positive) its performance is incomparably better. This is probably the result of a speculative bubble exacerbated in Japan but it is also the result of a much better European trend that allowed the indices to recover.



Conclusion: even if the Euro Stoxx has not completely recovered, and therefore not completely digested the past crisis, the difference with the dynamic of the Nikkei is impressive.

Japanification score : 2/5

Conclusion: major divergences

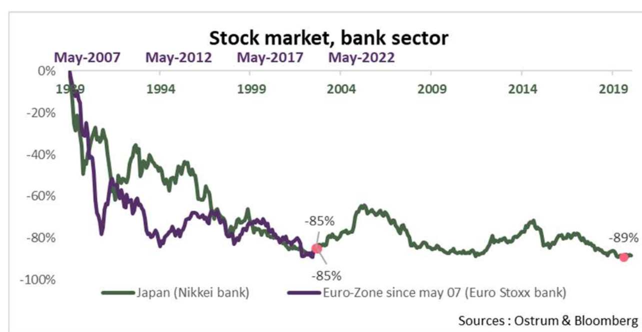
Is the Eurozone in a phase of japanification? The answer is ambiguous and this is the main message. There are undeniable similarities and parallels, the trajectory of growth in the first place, the demographic aspects of course but also the legacy of the crisis in terms of the financial sector being convalescent.

Themes	Japanification Indice
Demographics	4/5
Growth	5/5
Deflation	2/5
Monetary policy	1/5
Stock market	2/1
Average score	**2,8/5**

There are also significant differences on crucial topics, particularly in terms of monetary policy response. The result on some aspects is also inconclusive with, for example, a stock market performance that has still not erased the crisis but is much better in the European case.

The main point is then perhaps the fact that doubts remain and that the Eurozone is still under risk. It also means that the efforts made have put the area on a different trajectory than that taken by Japan, but that the battle is far from won. One of the main factors behind the Japanese slump is the health of its financial system, which has weighed on growth and prevented a more marked recovery.

The market performance of the European banking sector is surprisingly close to that of Japan. And this is very worrisome.



The diagnosis of the state of the European financial system is therefore key to understanding the future trajectory.

Stéphane Déo

Market review

Italian worries

The Italian crisis and the pullback in activity weigh on European markets contrary to the US where the S&P 500 hits record highs.

The reflation investment theme keeps driving market returns. The inauguration of Joe Biden as 46th President and his proposed $1.9T fiscal package have boosted recovery hopes and raised inflation expectations in 2021. In this context, monetary authorities seemingly turned more upbeat on the outlook. The ECB argued that PEPP may be reviewed in a symmetrical manner depending on the economic situation. The Bank of Canada pointed out that C$4b worth of asset purchases on a weekly basis already represents significant support to activity. In Norway, Norges Bank signaled a rate hike next year. The RBNZ now observe higher housing prices in the wake of monetary easing.

Christine Lagarde also responded to speculations regarding the underlying objective of monetary policy. The ECB is aiming at controlling spreads. That said, the ECB does not want to be seen as a daily market regulator at a time when Italian politics are back to haunt financial markets. Giuseppe Conte won confidence votes in both chambers of Parliament and passed a fiscal bill worth €32b voted last Wednesday but a fragile coalition, stretched to include Forza Italia, may result in early elections. The ECB keeps, in any case, a considerable impact on financial markets. The Central Bank may purchase €360 on our estimates in excess of expected net bond supply in 2021. The ECB will not hesitate to expand purchases at any time should the economic downturn, observable in incoming surveys, impact financial conditions negatively. The service sector downturn points to GDP contraction in the three months to March. Thus, the ECB will iron out volatility stemming from the see-saw growth pattern and tightening bank credit conditions.

In the US, Janet Yellen's Senate confirmation hearing for Treasury Secretary was an occasion to argue for pro-active fiscal policy. The meager democratic majority in US Congress and the complexity of US fiscal policy process will make the adoption of full $1.9T package uncertain. That said, the US economic situation is much better than in the euro area. Surveys indicate strong growth ahead whilst employment weakness appears traceable only to sectors faced with sanitary restrictions. Residential construction is strongest since the mid-2000s. The housing backdrop does raise the issue of Fed MBS buying worth $40b per month, even though the Fed is unlikely to alter policy at this juncture and will continue to fund the lion's share of the US federal deficit.

In bond markets, the accumulation of speculative long positioning after the 10-year bond auction early on in January draws a resistance about 1.15% on T-notes. That said, there are still significant shorts to cover on intermediate maturities (5 years) so that 5s10s steepening may have legs. The TIPS auction was met with solid demand confirming buying flows observed in the run-up in crude prices. OPEC supply in the short term entails significant support to breakeven inflation rates. The 10-year inflation swap rate is trading about 2.30%.

In the euro area, Christine Lagarde's communication sparked selling in Bund markets. The yield on 10-year bonds rose 3bp last Thursday amid broad-based steepening pressure, which may spur final investor buying interest. Bund yields closed last week at -0.51%. France sold a 50-year bond attracting un-heard of demand worth €75b. Italian BTPs reflect political risk as spreads widen on speculative flows. As BTP Apr31 traded at 0.75% yields at weekly close, Moody's issued a statement pointing out the risk of misusing European subsidies. The rise in Italian spreads caused upward pressure on Iberian debt spreads. Meanwhile, Greece made a private placement of 30-year bonds worth €2b with two local banks in need for ECB collateral. The transaction will not affect the annual financing program according to the Greek debt agency.

In credit markets, spreads have been stable on IG about 90bp against Bunds. Primary issuance (€11b) remains dominated by the non-financial issuers. ECB presence in primary markets keeps new issue premium about 0bp. Financials' bond issuance (in particular subordinated securities) is modest as cyclical sectors dominate volumes of late. Pan-Europeans high yield fared better with 11bp narrowing to 349bp.

As regards equity markets, the S&P index (+1.5%) make record highs driven by FANG weekly advance (+6.3%). On a sector basis, energy declined on the back of rumors of a fracking ban in the US, which would greatly impact the US shale oil industry. Europe underperformed due to renewed lockdown risk. Stocks that area most sensitive to economic reopening took a nosedive (-3%). Banks closed last week on a negative note. Corporate earnings have beaten expectations. China exposure and the digitalization investment theme continue to drive equity market returns. Lastly, strong demand for semiconductors underpin the sector's performance.

Axel Botte
Global strategist

Main market indicators

Emprunts d'Etats	25-Jan-21	-1sem (pb)	-1m(pb)	2020 (pb)
EUR Bunds 2a	-0.72 %	0	-1	-2
EUR Bunds 10a	-0.53%	0	+2	+4
EUR Bunds 2s10s	19 bp	+0	+3	+6
USD Treasuries 2a	0.12 %	-1	+0	0
USD Treasuries 10a	1.08 %	0	+16	+17
USD Treasuries 2s10s	96 bp	+1	+15	+17
GBP Gilt 10a	0.29 %	+0	+3	+9
JPY JGB 10a	0.05 %	-1	+3	+3
EUR Spreads Souverains (10a)	**25-Jan-21**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
France	24 bp	+1	0	+0
Italie	122 bp	+6	+9	+11
Espagne	62 bp	+2	0	+0
Inflation Points-morts (10a)	**25-Jan-21**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
EUR OATi (9a)	93 bp	-2	+9	-
USD TIPS	208 bp	-1	+11	+9
GBP Gilt Indexés	303 bp	-3	+3	+3
EUR Indices Crédit	**25-Jan-21**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
EUR Credit IG OAS	90 bp	-1	-3	-2
EUR Agences OAS	40 bp	+0	-2	-1
EUR Obligations sécurisées OAS	32 bp	0	-2	-1
EUR High Yield Pan-européen OAS	341 bp	-11	-21	-17
EUR/USD Indices CDS 5a	**25-Jan-21**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
iTraxx IG	49 bp	-2	+1	+2
iTraxx Crossover	259 bp	-1	+14	+18
CDX IG	51 bp	-1	-3	+1
CDX High Yield	304 bp	0	+6	+11
Marchés émergents	**25-Jan-21**	**-1sem (pb)**	**-1m(pb)**	**2020 (pb)**
USD JPM EMBI Global Div. Spread	357 bp	-2	-1	+5
Devises	**25-Jan-21**	**-1sem (%)**	**-1m(%)**	**2020 (%)**
EUR/USD	$1.216	+0.69	-0.29	-0.55
GBP/USD	$1.369	+0.78	+0.94	+0.26
USD/JPY	¥103.83	-0.13	-0.39	-0.51
Matières Premières	**25-Jan-21**	**-1sem ($)**	**-1m($)**	**2020 ($)**
Brent	$55.8	$1.1	$4.5	$4.0
Or	$1 863.6	$25.9	-$19.9	-$30.8
Indices Actions	**25-Jan-21**	**-1sem (%)**	**-1m(%)**	**2020 (%)**
S&P 500	3 841	1.21	3.74	2.27
EuroStoxx 50	3 598	-0.12	1.55	1.28
CAC 40	5 539	-1.39	0.32	-0.22
Nikkei 225	28 822	2.05	8.12	5.02
Shanghai Composite	3 624	0.78	6.70	4.35
VIX - Volatilité implicite	22.40	-7.97	4.04	-1.54

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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