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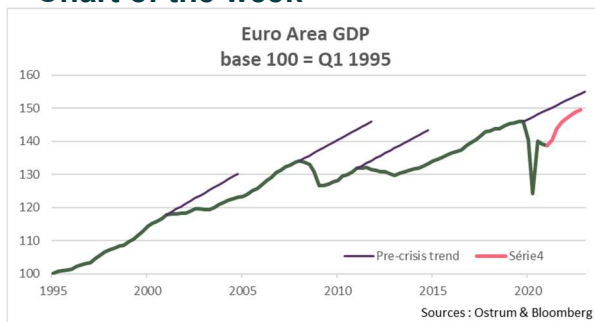
## ● Topic of the week: three topics for the markets

- The decline in US rates over the past two months seems to have a lot to do with short-term technical factors, in particular liquidity. These elements are temporary.
- The low level of VIX suggests that the market is very confident. A more careful analysis gives a more nuanced message, some measures of stress are at their all-time high.
- U.S. retail sales figures, beyond the impressive rebound, show a profound shift in consumption patterns.

## ● Market review: The Fed's pivot (again)

- Dot plot revised much higher;
- Massive curve flattening;
- Equity markets under pressure after 4-week rise;
- Credit spreads resist to Fed's hawkish shift.

## ● Chart of the week



Economic recovery in Europe is always partial. They do not allow to return to the trajectory on which the economy was before the crisis.

If we believe the consensus, the recovery we are experiencing will be no exception. By the end of 2022, the euro area's GDP will be 2.3% above its pre-crisis level (Q4 2019 level), but it will also be 3.2% below the pre-crisis trend.

A very rapid recovery that corrected the 2020 decline in a short time, but certainly not a return to normal.

## ● Figure of the week

# 756

Source: OECD

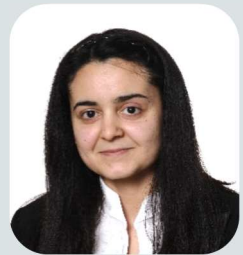
\$756bn, a record amount, that banks and money market funds paid back into the Fed's reverse repo facility after it raised its rate from 0 to 0.05%.



**Stéphane Déo**  
Head of markets strategy



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**Zouhoure Bousbih**  
Emerging countries strategist



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Developed countries strategist

• Topic of the week

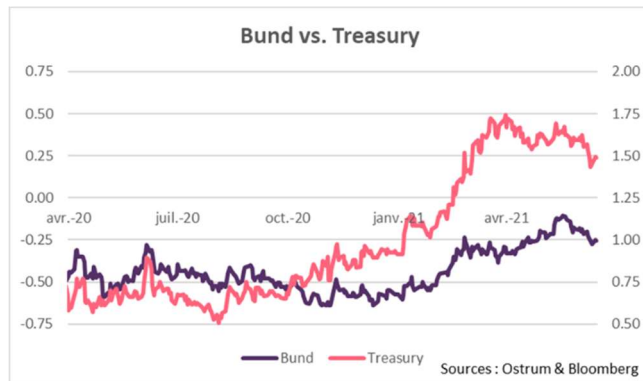
# Americans yields' yoyo

While fundamentals suggest higher rates, Treasury and Bund have tended to fall recently. The reason seems to us to be largely related to technical and market positioning reasons. Those are essentially short-term reasons.

## Why the drop in the last two months?

The economic data are unquestionably robust, the last two inflation figures in the US in particular were not only very strong but also well above market expectations. Paradoxically, since its April highs, the Treasury has fallen, by about 25 bps, while the Bund has dipped about half that range in recent weeks. Movements, we would argue, difficult to explain using the fundamentals.

It seems that technical movements played an important role in the recent movement.

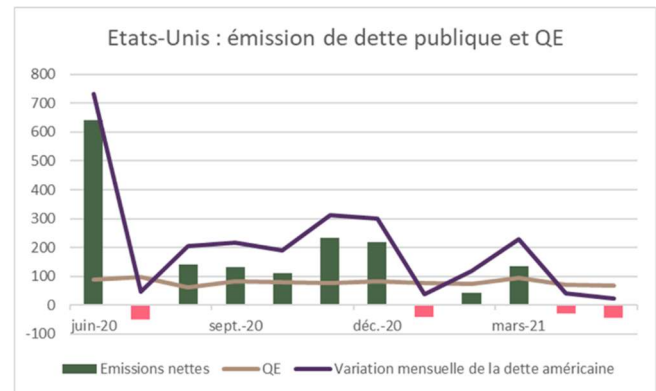


First, Treasury's net offer was negative in the last two months. The chart below shows that the change in the total debt of the US federal state is very volatile on a monthly basis. On the other hand, Fed' QE remains very stable at 80bn per month. In particular over the past two months, the US Treasury has used a lot of its cash reserves deposited with the Fed and thus issued little, 66.2bn cumulated over April and May.

The Fed therefore bought more than the issues and rarefied the paper available, almost 100bn over the past two months.

Second argument, the liquidity of the US Treasury deposited to the Fed is 674bn according to the latest weekly statement. This is a drop of almost 1 Tr since January. This liquidity is

therefore found on the balance sheet of commercial banks and ultimately on the money market. This resulted in strong distortions on the short part of the curve with T-Bills that yield in negative rates. The Fed has partially addressed this issue with its reverse repo operations which absorbed some of the liquidity and provided Treasury to the market (for more details see last week's MyStratWeekly "The Fed's Plumbing Business").



Third argument, a repositioning of certain "fast money" investors, in particular hedge funds. Flow data on future contracts shows significant purchases over the 10-year region of the Treasury curve, which depressed rates. The rumor of the market is that there are significant steepening positions that would be undone, which amounts to buying back Treasury on the 10-year part, which is suggested in the graph below.



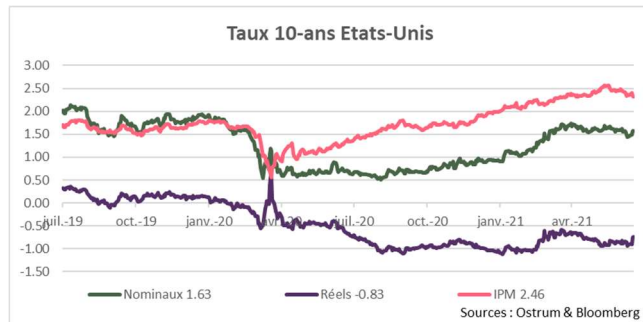
The most important point is that these three arguments, which partly overlap, are essentially short-term. They cannot justify continued low rates. Moreover, in all three cases the adjustment described is, to a large extent, completed. Hence the downward pressure on long-term rates should then gradually reduce or even disappear.

**If our explanation is correct, then US long-term rates should return on their upward path in the coming months. The strength of the fundamentals should help this movement.**

## Why the reaction to the Fed?

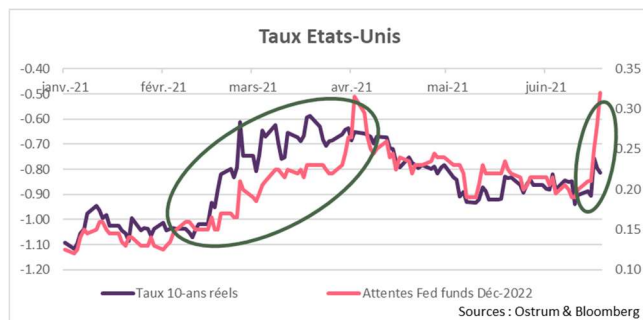
The Fed surprised the market (and surprised us too, admittedly) with a more "hawkish" turn than expected. For more details on the FOMC, see the "Market Review" section below.

The market has shown a nice schizophrenia this year. The chart below shows that inflation expectations, we take the 10-year inflation swap, were close to 2.1/2% for the coming decade. At the same time, nominal 10-year rates were close to 1.1/2%. Both numbers are more than difficult to reconcile: either inflation remains well above the Fed's target for a decade and nominal rates cannot remain as low; or nominal rates are where they should be, but in this case inflation expectations will have to deflate.



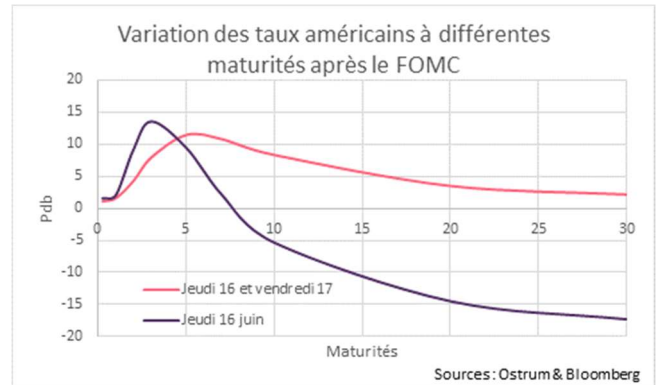
What happened Thursday after the FOMC has a precedent: January this year. Again, the divergence between inflation expectations and the level of nominal rates was hardly justifiable. As a result, the market has begun to validate the inflation trajectory, and thus to anticipate a more active Fed and indeed the probability of a Fed funds hike has increased from 15%; hence negligible, to more than double. At the same time, nominal rates, and therefore real rates, have gradually gone up.

In this case, "schizophrenia" has been resolved with the nominal rate side adjusting.



The same graph shows the post-FOMC situation, which is

similar to the episode at the beginning of the year. The dot-chart has been changed and therefore the expectations of Fed funds increases have adjusted. With Thursday night market data, we get 76% chance of a rate increase in 2022 (versus 60% with Tuesday night data) and we get 256% chance of rate increase in 2023 (two increases "fully priced" and 56% chance of a third). Against 228% on Tuesday night. Real rates followed and adjusted upward there as well.



If the real rates have adjusted, partly after the FOMC, it seems that the very strong divergence is not completely corrected. If the market increases its likelihood of Fed funds rising, real rates may continue on their upward path.

# The market is not as zen as it seems

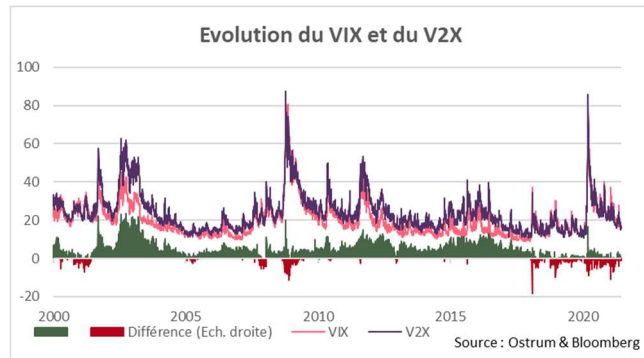
The very low level of the VIX, and its European equivalent the V2X, seems to suggest a high market calm. The reality is more complex, with other stress indicators at historical highs.

## Calm at first sight

The VIX, known as the “Fear Index”, measures implied volatility, that is, the one-month volatility expected on the S&P. Its European equivalent, the V2X, does the same for the Euro Stoxx.

These two indices are currently at extremely low levels. The VIX long-term average is 20.25, but in the year following the covid crisis, from mid-March 2020 to mid-March 2021, the index fell a single day below 20 (to 19.97 on February 12), a record high. Since then, the implied volatility has collapsed enormously.

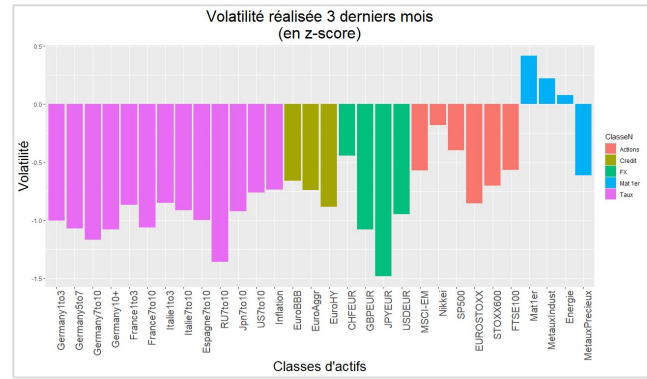
The V2X has followed a very similar trajectory, with an oddity to note however, since the beginning of 2018, the expected volatility on the Euro Stoxx is very regularly lower than that of the S&P, which was very rare before.



This low volatility is linked to confirmed growth prospects and vaccination progress. But it is also the wait-and-see attitude of the central banks, especially the Fed, which does not seem to be that worried about inflation at 5.0%.

## Other asset classes also

All of this provides visibility to markets. The following chart shows volatility across 30 asset classes. We used z-scores (deviation from the historical average) to compare all these asset classes. In all cases, aside from commodities, the level of volatility achieved over the last 3 months is much lower than the historical average. The calm suggested by the VIX level is therefore very widespread and also affects the sovereign, credit and foreign exchange markets.

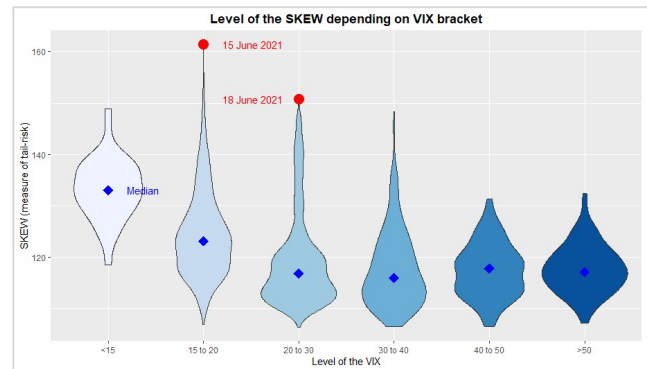


## Yes but: the “black swan”

If the market is very “zen” indeed, a careful view gives a more nuanced image. The VIX measures expected volatility on options that anticipate small variations. Another interesting indicator is SKEW, which measures the expected volatility over very large variations. The VIX can be seen as a measure of uncertainty around the central scenario, the SKEW as a measure of “black swan” risk, i.e. very large variations.

Why these details? While the VIX is at very low levels, the SKEW has broken several records recently and remains close to historical highs. This is partly due to technical considerations: with such a low VIX the protection purchase price is interesting and investors tend to protect themselves against a major correction. However, this shows a strong appetite for protection against large-scale correction.

The message is therefore more complex than reading the VIX alone suggests. **The market tells us both that it has confidence in its central scenario but that it is increasingly afraid of a large variation linked to a surprise.**





# Retail sales in full swing

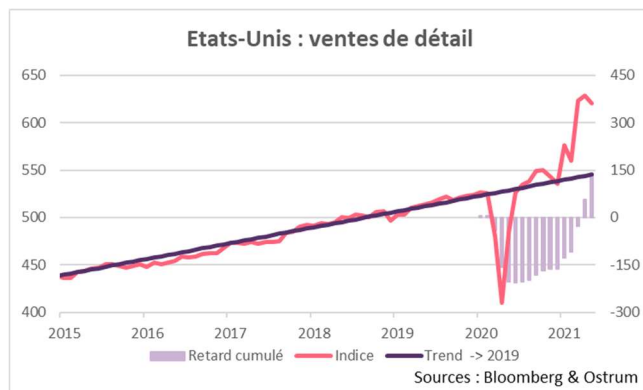
US retail trade figures, beyond their very high level, show a profound change in consumption pattern.

## Very high

Retail sales figures in the United States were a little disappointed for the month of May, a decrease of 0.7% over the previous month for retail trade excluding automobiles, while the consensus expected an increase of 0.4%. The level remains nevertheless very high, retail sales are still 18% above the pre-crisis level (compared to December 2019). A level that is not sustainable in the medium term.

More impressive, the chart below shows that consumption is so high that it has already made up for the gap of the Covid period. Comparing the retail sales observed to the pre-crisis trend, consumption was below this trend throughout the first half of 2021. Since then, retail sales overshoot compared to the pre-crisis trend, this has more than offset the drop in consumption.

As a result, retail sales in 2020-2021 are well above what they would have been without the pandemic. If the economy returns to its pre-crisis level, consumption has therefore done much better and completely compensated the loss of 2020.



## Behavioural change

The graph below shows the evolution of the market share of internet sales in retail sales.



The trend has been very clear over the last two decades with a continuous and rapid increase in internet sales.

Unsurprisingly, the market share in internet sales surged during the crisis from 13.1% in January 2020 to 19.8% by our calculations in April of the same year.

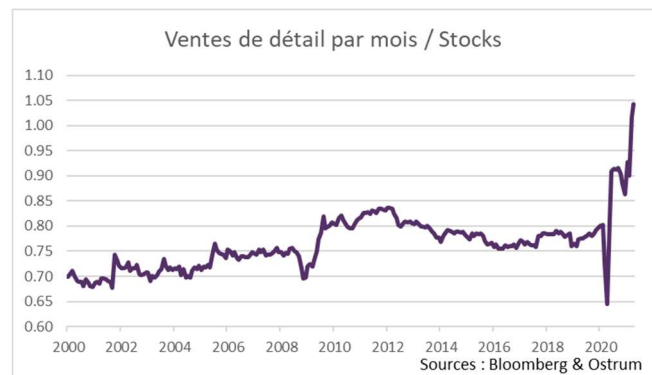
The interesting point, however, is that there is no return to full normalcy. If the deconfinement brought down this ratio, more than one ppt remains above the pre-crisis level. As a result, Covid has created new habits and accelerated the trend. Mail-order sales are becoming more prevalent.

## No more inventories

Another point to note on these figures is the very sharp decline in stocks. In normal times retail stocks are quite stable and represent the equivalent of 0.8 times monthly sales as shown in the chart below.

This ratio has exploded in recent months. This can be attributed to a consequence of our first remark: consumption has not only returned to pre-crisis levels, but the cumulative consumption has made up for all the delay and thus absorbed all the accumulated retailers' stocks. The stock ratio is thus a further indication of supply pressures and bottlenecks.

Another explanation is the share of internet sales, carried out more in just-in-time flow and therefore requiring less inventory. In this case, the shift in the ratio would not be purely cyclical.



**Stéphane Déo**

• **Market review**

## The Fed's pivot

### Reallocations and volatility after the FOMC

"Listen to what I say but also watch what I do" seems to be the message from the Fed. After the announcement of a change in monetary stance, bond yields fell again as financial markets digested the more restrictive rate projections. Two-thirds of FOMC members now admit that inflation risks are on the upside. However, the technical factors, which had kept downward pressure on bond yields since mid-March, were amplified by the increase in administered rates. The resulting flattening of the yield curve raises the value of future earnings, allowing the Nasdaq to set new highs. The US dollar is up as inflation expectations adjust lower. Credit spreads are broadly stable except for MBS.

The development of the rate outlook reflected in the 'dot plot' surprised the financial market participants. The dot chart shows major differences of opinion among central bankers. Five FOMC members, probably some Board members and doves such as Neel Kashkari, still expect status quo on Fed funds rates by December 2023. In contrast, two participants forecast Fed funds rates to rise to 1.75% (upper bound), which would require a 50bp increase from 2022 and four movements of 25bp in 2023. The range of possible rate outcomes has therefore broadened significantly. The change in rate projections relates to the outlook for inflation. Thirteen of the eighteen FOMC members now consider inflation risks to be on the upside. In March, a large majority of policymakers saw inflation pressures as balanced. Implicitly, if maximum employment target remains a top priority, the Fed will no longer ignore the deviation of inflation from the price stability target. In addition, there is considerable uncertainty regarding the return to employment of part of the population that left the labor force since the start of the pandemic. Among these 100mn individuals, 7 million say they want to work (NB: without looking for a job otherwise they would be included in the workforce). In May 2020, that figure stood at 9.4mn. In other words, 2.4mn people have left the labor market for good. This represents a loss of potential GDP that expansionary fiscal and monetary policies are likely to bump against, thus accentuating the pressure on prices.

Meanwhile, the Fed opted for technical adjustments, which do not involve monetary tightening. By raising the IOER and the reverse repo rate, the Fed wants to move away from negative rates in parts of money markets. T-bill rates induced by the scarcity of collateral since mid-March have risen above zero. By hiking administered rates by 5bp, the Fed is subsidizing the purchase of collateral and promoting better functioning of the money markets (by avoiding a fall in net asset value of money market funds). Compared to the

pre-FOMC conditions, the Fed now borrows liquidity from institutions 4bp above market repo rates. The hikes led to a dizzying increase in the usage of the reverse repo facility from \$ 520 billion before the FOMC to \$ 756 billion the day after. In other words, despite the restrictive message, the Fed favored the purchase (temporary but tacitly rolled daily) of \$ 236 billion worth of Treasuries in just one day.

These technical elements are undoubtedly key drivers in the very strong flattening movement of the US yield curve. The 5-30 year spread (120bp) tightened by 20bp in two days to return to its December 2020 level. The 10-year note yield quickly reverted to pre-FOMC levels around 1.50%. Two-year Treasuries moved above 0.25% following further hawkish comments from James Bullard. The lack of consensus on rates within the Fed will foster volatility. Investors logically seek to hedge against higher volatility by opting for more convex strategies (protective on both the rise and fall of rates), such as the yield curve flatteners. The search for collateral should sustain this curve flattening momentum, as the end of the suspension of the debt ceiling (end of July) may weigh on the perceived ability of the Treasury to raise marketable debt.

In the euro area, the Bund logically follows the leading US market. Taking into account the 5bp term premium on the new 10-year benchmark, German bond yields are up 3bp from a week ago. Hedging needs relating to EU NextGen bond issuance resulting in Bund selling following the 10-year bond syndication worth an unprecedented € 20 billion. Final investor demand reached a total of € 142 billion. The EU continues to offer large new issue premiums (mid swap – 2bp) compared with secondary market spreads around 5bp lower. Against this backdrop, sovereign spreads ended the week on a slightly negative note, as did swap spreads.

The primary investment grade credit market remains very lively, in particular the financials' sector (€ 9 billion this week). These securities tend to tighten in secondary markets, as appetite for long maturities remains strong, probably due to the flattening of the underlying yield curves and the historical level of yields in the 1-3 year credit bucket. High yield is experiencing unprecedented primary activity with 16 to 18 transactions expected by the end of June. Fund positioning is bullish around two main investment themes: the possibility of rating upgrades among BBs and the reopening of economies.

Stock markets resisted the FOMC's hawkish pivot for a while, but Friday's four witches' session weighed on indices. The earnings season is shaping up to be favorable and inflows are supporting the asset class. Annual earnings will be up 50% from 2020. Sector rotation is unfavorable to raw materials but benefits luxury goods. The dollar strengthened against any currency following the FOMC. The euro plunged to \$ 1.19. Currencies linked to commodities fell. The Brazilian real is an exception thanks the 75bp Selic rate hike.

**Axel Botte**  
Global strategist

## ● Main market indicators

<b>G4 Government Bonds</b>	<b>21-Jun-21</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR Bunds 2y	-0.65 %	+2	+0	+5
EUR Bunds 10y	-0.18%	+8	-5	+39
<b>EUR Bunds 2s10s</b>	<b>48 bp</b>	<b>+6</b>	<b>-5</b>	<b>+35</b>
USD Treasuries 2y	0.25 %	+9	+9	+13
USD Treasuries 10y	1.46 %	-3	-16	+55
<b>USD Treasuries 2s10s</b>	<b>122 bp</b>	<b>-12</b>	<b>-25</b>	<b>+42</b>
GBP Gilt 10y	0.76 %	+2	-7	+57
JPY JGB 10y	0.05 %	+1	-3	+3
<b>€ Sovereign Spreads (10y)</b>	<b>21-Jun-21</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
France	34 bp	-4	-4	+11
Italy	105 bp	+2	-11	-7
Spain	63 bp	-2	-6	+1
<b>Inflation Break-evens (10y)</b>	<b>21-Jun-21</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR OATi (9y)	130 bp	-10	-5	-
USD TIPS	225 bp	-12	-20	+26
GBP Gilt Index-Linked	346 bp	-10	-16	+46
<b>EUR Credit Indices</b>	<b>21-Jun-21</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR Corporate Credit OAS	83 bp	+0	-1	-9
EUR Agencies OAS	42 bp	+2	+3	+1
EUR Securitized - Covered OAS	33 bp	0	+5	+0
EUR Pan-European High Yield OAS	293 bp	+6	-7	-65
<b>EUR/USD CDS Indices 5y</b>	<b>21-Jun-21</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
iTraxx IG	48 bp	+1	-4	+0
iTraxx Crossover	238 bp	+6	-23	-4
CDX IG	50 bp	+2	-2	+0
CDX High Yield	283 bp	+6	-12	-11
<b>Emerging Markets</b>	<b>21-Jun-21</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
JPM EMBI Global Div. Spread	338 bp	+8	+6	-14
<b>Currencies</b>	<b>21-Jun-21</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>YTD (%)</b>
EUR/USD	\$1.192	-1.69	-2.19	-2.46
GBP/USD	\$1.392	-1.4	-1.66	+1.79
USD/JPY	¥110.15	-0.07	-1.08	-6.26
<b>Commodity Futures</b>	<b>21-Jun-21</b>	<b>-1w k (\$)</b>	<b>-1m (\$)</b>	<b>YTD (\$)</b>
Crude Brent	\$74.1	\$1.3	\$7.8	\$22.8
Gold	\$1 785.9	-\$80.3	-\$95.4	-\$112.5
<b>Equity Market Indices</b>	<b>21-Jun-21</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>YTD (%)</b>
S&P 500	4 215	-0.94	1.42	12.22
EuroStoxx 50	4 111	-0.52	2.12	15.72
CAC 40	6 602	-0.21	3.38	18.93
Nikkei 225	28 011	-3.95	-1.08	2.07
Shanghai Composite	3 529	-1.69	1.22	1.62
VIX - Implied Volatility Index	18.54	13.12	-7.99	-18.51

Source: Bloomberg, Ostrum Asset Management

## Additional notes

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