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● **Topic of the week: Peripheral yields, the remontada**

- The rate increase has certainly been unusually rapid. We have to go back to the 1994 bond market crash to find a more violent episode;
- There is however no alarming sign of market overreaction or of panic. Instead, this seems to be a normalization of risk premiums that had been artificially squeezed by the ECB's QE;
- For sovereigns, there is no (yet!) great danger. Market levels allow them to issue debt at a stable cost relative to existing debt.

● **Market review: The Fed insists on inflation**

- The tightening of financial conditions continues;
- Solid US retail sales;
- Huge volatility on equities, the T-note benefits from it;
- Tensions on credit amid continuous fund outflows.

● **Chart of the week**



The NY Fed global supply chain pressure index is back up and is settling above three standard deviations from its long-term average. Supply chain pressures are indisputably still very high and unfortunately the latest data do not show yet any sign of improvement.

In terms of components, unsurprisingly, the main contributor to the stress is the "Asia outbound" component. This is a direct consequence of the China lockdown that is taking a toll on world growth.

● **Figure of the week**

59%

Source : Ostrum AM

That's the proportion of the components in the Euro CPI index that have 4% or more inflation. This is totally unusual. It's a sign that inflationary pressures are spreading to a large number of sectors.



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• Topic of the week

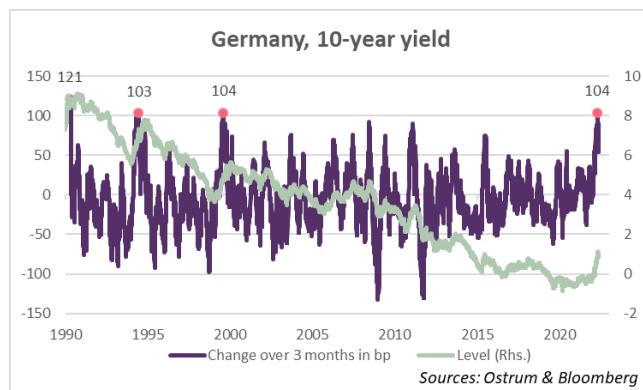
Peripheral yields, the remontada

The yield increase was accompanied by a similar move in peripherals spreads. We propose an approach in terms of risk premium to analyze whether this deviation is insufficient, justified or exaggerated. That's the investor's perspective. What about the borrower's? Sovereigns have benefited greatly from lower rates to improve their debt service. The rebound of the current yields is a worrying news even if the situation is, for the moment, far from being alarming.

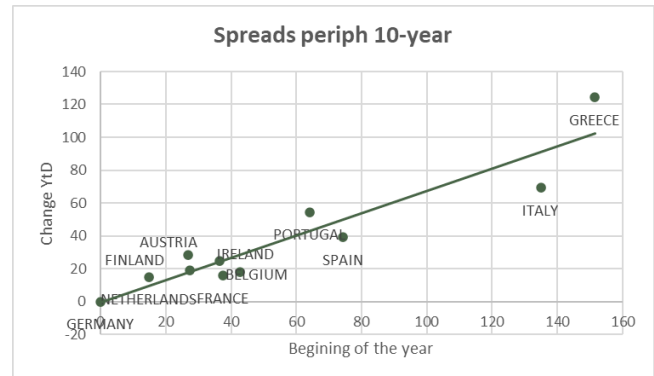
Rebound

At the beginning of the year German 10-year rates were still negative, -0.18% at the very beginning of the year. At the time of writing, they tested 1% and even passed over 1.13% during the first week of May.

To put things in perspective, in the chart below, we look at the change in rates over three months. The Bund gained over 100 bps between January 22 and May 22. A variation of this magnitude is extremely rare, and it is even necessary to go back to the last century, in August 1999, to find a similar movement.



Of course, the tide took with it the other countries and the peripheral spreads have increased in sync. It is interesting to note that the movement has been very homogeneous in other countries as shown in the graph below. The increase in spreads was largely homothetic: by multiplying the spread level at the beginning of the year by a factor of 1.5, the current level is obtained with very high reliability.



To be more precise, and with little more econometrics, we find that 95% of spreads movements since the beginning of the year can be explained by the risk premium. The rest is idiosyncratic. This last part, as we can see, is negligible.

The idiosyncratic risk has moved very little (it is nothing to do with French elections or Italian exposure to Russian gas), it is very essentially a common movement of widening spreads, thus an increase in the risk premium.

This may be due to the risk on growth associated with the Ukrainian crisis and other factors. It is also closely linked to the ECB's announced reduction of QE, which has been already significantly reduced and is likely to end this EQ at the end of June.

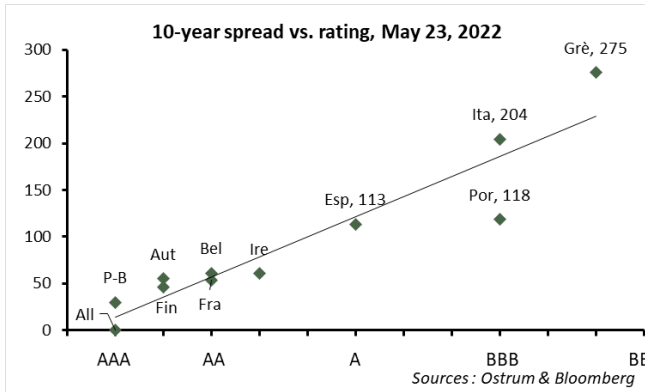
Risk premium

The question for investors then is whether the current risk premium is excessive, reasonable, or still below normal.

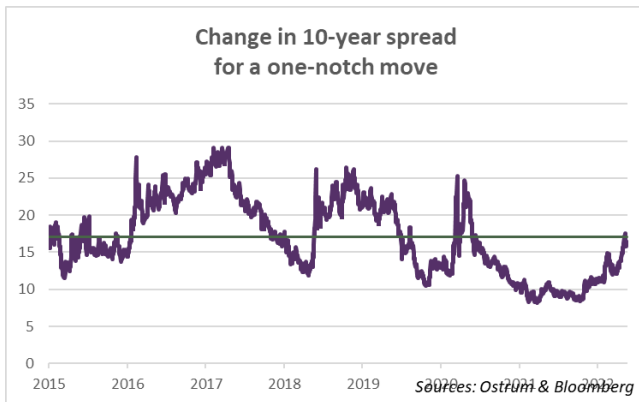
To do this we look at the chart below which compares the ratings of the 11 main euro zone countries and their spreads. Of course, there is a very close relationship between the two, with investors demanding an increasing premium in compensation for the deterioration of ratings.

At the time of writing, the slope of the curve on the graph is 16 bps per rating unit excluding Greece which tends to bias estimates. In other words, each unit's rating movement (called a "notch" in market parlance) results, on average, in a change in the country's risk premium of 16 bps. This figure is therefore a measure of the risk premium.

At the very beginning of the year, spreads were lower, the slope was flatter, close to 11 bps. This is a good illustration of the fact that the risk premium has increased since the beginning of the year. And we find back the magnitude of the adjustment mentioned above.



The graph below shows the evolution of this risk premium since 2015. Why 2015? On the one hand because the Banking Union was introduced at the end of 2014 and has significantly changed the risk profile of European states by helping to break the vicious circle with banks. For more details, see *MyStratWeekly* from last week. On the other hand, because the period before that date was that of the sovereign crisis where risk premiums have reached galactic levels that have nothing to do, at least we can hope so, with a “normal” world. It therefore seems to us that the period reviewed provides a relevant basis for comparison.



If this is the case, the message of the chart is relatively simple. Rather, it was the level at the beginning of the year, with a risk premium close to 10 bps that was abnormally low. While the current level, around 16 bps, is close to the long-term average. We understand what was happening at the beginning of the year, the ECB’s QE, still very dynamic, artificially compressed the yield spreads. Hence an unusually and artificially low risk premium. As the ECB withdraws, market prices return to a more “normal” level.

In conclusion, there is no alarming sign of oversupply of markets or of panic. Far from it.

- However, if the risk premium were to increase to 20 bps, which is still very reasonable, France’s spreads would increase to over 60 bps, Spain and Portugal would increase to 135 bps and Italy would increase to 240.
- If the risk premium were to increase to 25 bps, which is less reasonable but quite conceivable, then we would have as an order of magnitude for

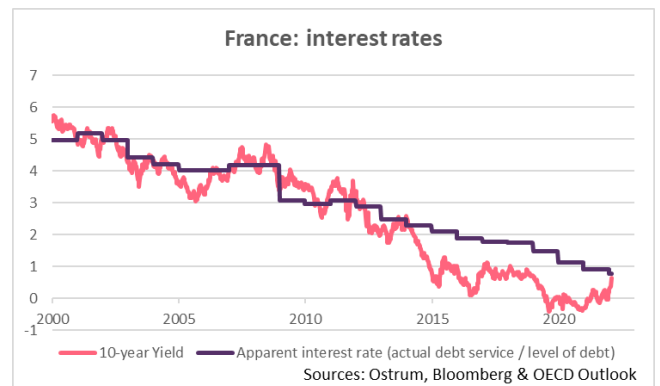
the same countries: 78 bps in France, 170 bps in Spain and Portugal, 300 in Italy. So we’re not necessarily done yet.

Bearable?

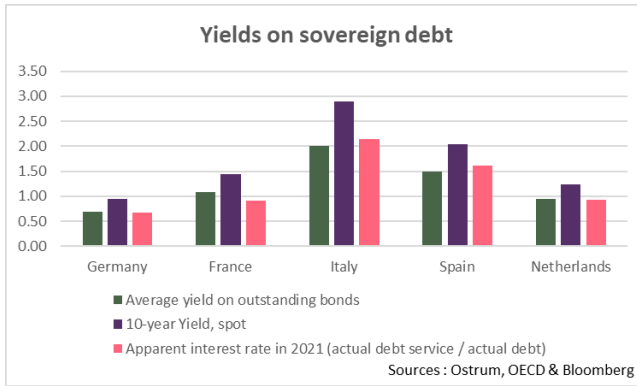
So far we have only taken the investor’s point of view and analysed the return it requires. What about the borrower? Higher rates are a higher interest burden and therefore a problem for public finances.

In a previous *MyStratWeekly* we introduced the idea of “apparent interest rate”. In economists’ jargon, it’s the observed debt service, divided by the level of debt, so it’s the actual cost of the public debt. Let’s take an example: according to OECD figures, French debt was 2.850 billion in 2021 and debt service was 26 billion over the year. The ratio between the two is 0.92%, which is the average rate paid by the CRF on French debt last year – the “apparent rate”.

To go back to the case of France, the “apparent rate” is therefore lower than the 10 year rate, which is close to 1.5% at the time we write. Market rates have remained almost systematically below the apparent rate since the beginning of the century as shown in the chart below. And so the issuance of new debt is at a lower level than the historical rate, which implies a gradual decline in the “apparent rate”. Unfortunately, in the case of France, the 10 year has just risen above it.



We need to be more specific, however. Of course, countries borrow not just at a 10 year maturity, but over the entire curve. The cost of issue is therefore an average of the rates at different maturities. On the graph below, we calculated the average rate for the five major euro area countries, weighting the maturities according to the size of the existing borrowings. This approach therefore gives a good approximation of the average rate at which new borrowings will be issued.



To come back to the case of France, our calculations show an average rate at 1.08%, which is slightly higher than the apparent rate of 0.92%. This means that, as the French Treasury issued, the average rate paid on loans with a tendency to rise. But we are still at very low levels, and progress is very slow. In fact, it would be more appropriate to talk about stabilization.

It should be noted that Germany and the Netherlands are in the same situation with average rates on their curve which, again, have slightly passed over the apparent rate.

In contrast, Italy and Spain remain in a more favorable situation. This is the consequence of the much higher spreads that existed on these countries in particular before 2015 and which therefore raised the historical cost.

In general, however, the gap is small. For all these countries, the market levels are therefore somewhat similar to the rates paid by the countries on their existing debt. While all these countries have benefited from an impressive reduction in their debt costs, it seems that the trend is coming to an end. To give an order of magnitude, the OECD estimates the French debt service at 26.1 billion in 2021 compared to 50.4 billion in 2010. While over the period the ratio of debt to French GDP has gained almost 30 ppt.

Generally speaking, therefore, there is no real danger. Market levels allow sovereigns to issue debt at a broadly stable cost compared to the existing one.

This view is nevertheless to be nuanced. If the photo is not particularly worrying, the trajectory is more challenging. A rise in rates, or continued spreads, would quickly put levels of borrowing rates on a much more complicated trajectory for some countries. It should also be remembered that the greater the debt stock, the greater the sensitivity of public finances to a rise in interest rates. We've had higher rates, and even much higher rates in the past, but the states didn't have the level of debt that they currently have. This hypersensitivity is also a source of risk.

Conclusion

So far so good. The increase in rates has certainly been unusually rapid, since we have to go back to the 1994 bond market to find a more violent one. Despite this, peripheral spreads levels have finally returned to normal. This is to the extent that the average change since 2015 can be described as "normal". Rather, it was the ECB's aggressive QE period during the Covid episode that had been unusually tight on spreads.

We reach a similar conclusion if we take the point of view of the borrower, that is to say of the sovereign. The average issue cost for the five major countries is currently close to the average cost of their existing debt. If the curves stabilize, the apparent interest rate on government debt should therefore remain stationary. Here too the movement looks, to some extent, like a return to normality.

An overreaction of the rates is nevertheless entirely plausible. In this case the very high debt stock creates a high sensitivity to rates and the situation could quickly become much more complicated. So, we have to hope that the adjustment is largely finished and that the markets will not decide to "over-adjust". This cautious conclusion can also be linked to rumors of a sovereign spreads control mechanism designed to avoid this dynamic and the possible loss of issuer market access, as in 2011 with the SMP.

Stéphane Déo

• **Market review**

The Fed insists on inflation

Treasuries regain their safe haven status, volatility in equities

Stock market volatility is not abating. The daily range of prices regularly exceeds 3% without any real direction for markets. A new element appears nevertheless, equity selling is no longer systematically accompanied by a rise in the US dollar. However, the message from the Fed has hardened. Esther George, President of the Kansas City Fed, insists on the need to reduce inflation, the tightening of financial conditions is thus inevitable. The Fed put is moving away. The US dollar's decline follows bond yields falling below 2.80% to the week's low on the T-note. Bonds somewhat regain their role as a safe haven during phases of acceleration to the downside in equities. Financial markets are more concerned about growth prospects than central bankers, who favor the objective of price stability. The showdown between the Fed and the markets will undoubtedly last. Credit indices (CDS) and spreads on corporate debt reflect the same anxiety, with the crossover approaching the 500 bp threshold. The trend towards wider spreads is picking up on peripheral sovereigns. France and the highest-rated sovereign bonds are spared, however.

In the United States, growth remains inflationary due to multiple supply constraints. In addition to the tightness in the US labor market (3.6% unemployment), the manufacturing capacity utilization rate continues to increase (79%). Industrial production grew by more than 12% in annualized terms between January and April. Mining and oil production are benefiting from the high price environment. On the demand side, retail sales are growing rapidly (+16% in annualized terms YTD). The "Pigou" effect on real cash balances does not seem to slow down demand at the macroeconomic level. Yet, inflation remains the main source of concern for households. Price stability must therefore be the Fed's main policy objective in the short term. Jerome Powell and Esther George make no secret of central bankers' desire to tighten financial conditions. This is the only way the Fed can reduce excess aggregate demand. The rise in mortgage rates, following increases in Fed rates and the announcement of quantitative tightening starting in June, is already having an effect on the traffic of prospective buyers on the residential real estate market and the number of home sales. The cost of housing indeed explains a significant part of the acceleration in the prices of services. In China, activity remains depressed despite the expected easing of lockdown measures within a month. The objective of 5% growth in 2022 is likely out of reach. The benchmark 5-year lending rate was lowered by the PBoC in the hope of

stimulating sluggish credit demand (stemming from weak real estate demand, excess involuntary savings). Monetary easing may not work. A fiscal support plan could prove necessary in view of the renewal of Xi Jinping's mandate in the fall.

Fears about economic growth are causing outflows from risky assets in favor of Treasuries and sovereign debt. Credit and equities are sold. In addition, volatility no longer benefits the greenback. The appreciation of the dollar this year arguably leaves little room for a new bullish run. Parity on the euro-dollar exchange rate may still be a tempting technical objective, but the tentative rebound in the yen (128) indicates a change in trend. The pressure on the yuan is also abating with the PBoC holdings its 1-year rate at 3.70%. In the fixed income markets, the T-note traded below 2.80% amid an acceleration to the downside in equities. The anchoring of short rates implies pressure to flatten the 2-10 year spread. The reactivity of 10-year bonds explains part of the observed widening in the 10-30 year spread. Demand for security and a lackluster TIPS auction are contributing to a narrowing of inflation breakevens (which also result from technical effects related to monthly carry). Oil is not in question as the WTI barrel is trading above \$112 and refining margins are at their peak. In the euro area, the yield curve is flattening as central bankers reaffirm the need to exit negative rates. The Bund fluctuates between 0.90% and 1.10%. Persistent risk aversion is coming back to haunt peripheral spreads. The Italian 10-year bond is approaching 200 bp. After a period of cutbacks in peripheral debt overexposures, the imminence of the end of QE prompts the establishment of new short positions. On the other hand, core sovereign bond remained stable. The 10-year OAT is trading about 50 bp. European credit continues to adjust. Despite high new issue premiums, nearly two-thirds of bonds issued in May have seen their valuations deteriorate since their launch. The average spread on credit in euros (169 bp) has tightened by 18 bp since the beginning of the month. The high yield spread change is consistent with the regular 3x elasticity to the change in the IG spread.

Equity volatility is considerable. Investors are watching for signals of investor capitulation. The number of stocks above their 200-day average has decreased but is not yet around all-time lows. The decline in the US big cap stocks and the rise in correlations between equities give a sense of the magnitude of the market correction. The Nasdaq is down 8% in May. The catastrophic earnings of retail companies (Walmart, Target), unable to maintain margins, seem to contradict the macroeconomic retail sales data. In Europe, market losses are lower (2%) so far this month. That said, value stocks with high dividend yields offer the only escape.

Axel Botte
Global strategist

● Main market indicators

G4 Government Bonds	23-May-22	1w k (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.37%	+24	+9	+99
EUR Bunds 10y	0.97%	+3	-1	+114
EUR Bunds 2s10s	58.7bp	-21	-10	+15
USD Treasuries 2y	2.6%	+3	-7	+186
USD Treasuries 10y	2.81%	-7	-9	+130
USD Treasuries 2s10s	21.1bp	-10	-1	-56
GBP Gilt 10y	1.94%	+21	-2	+97
JPY JGB 10y	0.24%	-1	-5	+2
€ Sovereign Spreads (10y)	23-May-22	1w k (bp)	1m (bp)	2022 (bp)
France	52.29bp	+1	+0	+15
Italy	199.57bp	+9	+16	+64
Spain	110.24bp	+4	+7	+36
Inflation Break-evens (10y)	23-May-22	1w k (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2.83%	+1	-12	+73
USD 10y Inflation Swap	2.89%	-10	-24	+11
GBP 10y Inflation Swap	4.49%	-23	-14	+32
EUR Credit Indices	23-May-22	1w k (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	168bp	+0	+32	+73
EUR Agencies OAS	65bp	+1	+4	+16
EUR Securitized - Covered OAS	73bp	-1	+1	+27
EUR Pan-European High Yield OAS	505bp	+1	+89	+187
EUR/USD CDS Indices 5y	23-May-22	1w k (bp)	1m (bp)	2022 (bp)
iTraxx IG	98bp	+5	+15	+50
iTraxx Crossover	481bp	+33	+85	+239
CDX IG	90bp	+4	+11	+41
CDX High Yield	517bp	+29	+83	+225
Emerging Markets	23-May-22	1w k (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	489bp	+20	+77	+121
Currencies	23-May-22	1w k (%)	1m (%)	2022 (%)
EUR/USD	\$1.066	2.166	-0.495	-6.2
GBP/USD	\$1.258	2.086	-1.295	-7.1
USD/JPY	JPY 128	1.270	0.470	-9.8
Commodity Futures	23-May-22	-1w k (\$)	-1m (\$)	2022 (%)
Crude Brent	\$113.3	-\$1.0	\$7.1	49.38
Gold	\$1 856.1	\$31.9	-\$41.8	1.47
Equity Market Indices	23-May-22	-1w k (%)	-1m (%)	2022 (%)
S&P 500	3 941	-1.68	-7.75	-17.3
EuroStoxx 50	3 683	-0.05	-4.08	-14.3
CAC 40	6 303	-0.71	-4.23	-11.9
Nikkei 225	27 002	1.71	-0.38	-6.2
Shanghai Composite	3 147	2.38	1.94	-13.5
VIX - Implied Volatility Index	29.44	7.17	4.36	71.0

Source: Bloomberg, Ostrum AM

Additional notes

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