

STRATEGY WEEKLY

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ECB faced with moral hazard

Key Points

- **ECB to discuss QE exit this week**
- **Italian crisis unlikely to change ECB strategy**
- **Fed: rate hike justified by growth and rising inflation**
- **Italy BTP: beware of 30-year bond auctions this week**

Volatility tied to the political situation in Italy remains. Spread did narrow following statements from Fin Min Giovanni Tria ruling out euro exit. Ten-year BTP spreads are trading around 240bp against Bunds. The German benchmark yield (0.50% on 10-year tenors) rose as ECB will start discussing the end of its purchase programme. Swap spreads have widened as did core sovereigns. CDS spreads of subordinated financials' debt have also increased. Conversely, European remain remarkably insensitive to the expected winding down of monetary support.

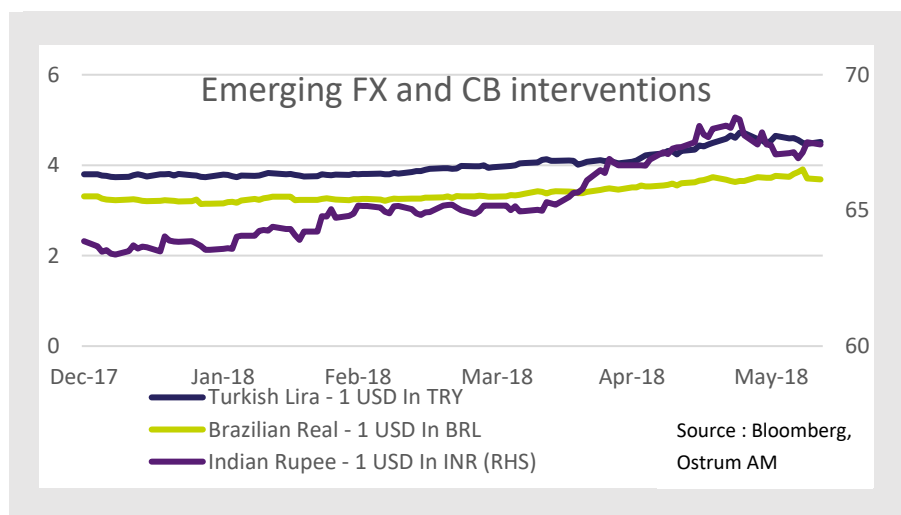
In the US, T-note yields are approaching 3% again as the S&P500 equity index gained 1.6% last week

ahead of the FOMC. Volatility remains tame on US equity markets.

Emerging bond spreads in US dollars have stabilized near 345bp, but the trend looks challenging in Latin American markets. The electoral backdrop and uncertainty regarding US trade policies after the G7 fiasco entail risk factors. This does affect attractiveness of local-currency funds.

BCB has had to support the Brazilian currency (3.70 against the dollar). Turkey's central bank also tightened policy by raising rates above 20% to stem selling pressure on Lira.

Chart of the week



Central bank in emerging economies have to fight currency depreciation.

In Brazil, BCB intervened in FX markets to bring USDBRL down from 3.95 to 3.70.

Turkey raised rates by 125bp to 20.75%. Lira stabilised about 4.50 against the greenback.

Reserve Bank of India raised rates to 6.25% and will take measures to stem portfolio investment outflows.

ECB QE and moral hazard

The European Central Bank will meet on Thursday, a day after the FOMC. Peter Praet, who has long argued against QE reduction, announced last week that the ECB will have a formal discussion on QE exit. The most likely outcome would be for asset purchases to end in September. The alternative is to prolong asset purchases until year-end at a reduced monthly pace. The balance sheet of the monetary institution represents 40pp of GDP, which exposes the ECB to significant risks. Furthermore, early announcements in terms of fiscal measures in Italy highlight moral hazard inherent to accommodative monetary policy. Unilateral action from the Italian government to let public deficits diverge from existing fiscal commitments risk depreciating the euro (\$1.18) and raising borrowing costs for other euro area member countries. Contagion from the Italian crisis onto Spain (95p on 10-year bonds) and Portugal spreads (145bp) is indeed one such example. ECB did not intervene in markets to stem BTP volatility. This is a signal that the ECB does not want to operate under fiscal dominance.

Peter Praet's comments initiated a selloff in Bunds to 0.51% before yields came in under the 0.50% mark. On technical grounds, current market equilibrium must be about 0.42%. If bond yields remain above this level, a short duration stance appears warranted. Italian debt is nevertheless volatile. Auctions of 30-year BTP bonds on June 13 (totalling €3b) will be a test of the new government's credibility in terms of fiscal discipline. The widening in swap spreads (52bp on Bunds) suggests that risk aversion has risen. Our preference for Spain's bonds is reaffirmed, particularly against Italian bonds.

Beyond peripheral sovereign markets (including credit), contagion from the Italian crisis has been limited. Equity market volatility is low with V2X at 14%. The Italian equity correction in May only erased outsized outperformance in the MIB index earlier this year. At the European level, basic resources, technology and chemicals show the highest performances. Conversely, automobile and transport sectors suffer since the start of the month.

In credit markets, financials appear volatile. The average excess spread vs the overall market (115bp against Bunds) has risen to 16bp. The upcoming end of QE does not affect high yield markets where spreads have stabilised about 365bp. Flows in and out of high yield ETFs have balanced out in the recent period.

FOMC to hike rates as planned

The Fed will announce an increase in the Fed Funds rate to a 1.75-2% range. The rate rise is fully justified

by faster growth and accelerating inflation. The number of rate hikes until December 2019 may stay unchanged. That said, the interest rate on excess reserves (IOER), which currently matches the upper bound of the Fed Funds range, will likely be raised by only 20bp (hence to 1.95%). The IOER change aims at dealing with several issues. It is worth addressing the significant fiscal impact of IOER and improve the Fed's transfer to the Treasury. Furthermore, banks will be incentivized to hold treasury bills or bonds instead of depositing excess cash with the Fed. This will facilitate balance sheet reduction. These arbitrages will steepen the term structure of money market rates. In the long run, the Fed may stop remunerating excess reserves.

In terms of strategy, the current level of 10-year yields is in line with our modelled fair value (2.96%). That said, the negative term premium remains an anomaly. The macroeconomic backdrop (reflected in high equity prices) argues for higher bond yields, via a reduction in the term premium. The bid for security in the context of Italian woes and current short speculative positioning continue to prevent a T-note selloff. The spread on T-note vs. Bund has come in below 250bp. In addition, curve flattening remains the trend in US bond markets.

The rebound in yields has caused no increase in breakeven inflation rates. This may be a surprise considering the recent rise in inflation. The stabilization in oil prices as OPEC stands ready to raise production and the dollar rally since mid-April have reduced market appetite for TIPS. Valuations in US inflation-indexed securities are nevertheless quite attractive.

In foreign-exchange markets, imminent changes in ECB communication on QE benefitted the euro. The single currency trades near \$1.18. The Swedish Krone is also a beneficiary of a change in ECB policy. Currency weakness across Latin America is confirmed. Brazil's Central Bank was forced to intervene in foreign-exchange markets. The real's exchange rate improved from 3.95 against the dollar to a 3.70 rate. The electoral campaign in Mexico and unreasoned protectionist threats by Donald Trump have raised volatility on the peso. About 20.40 pesos for one dollar (-2% last week), the Mexican currency is now 3% lower than year-end quotes.

Currency volatility was likely a factor in the acceleration in outflows from local-currency bond ETFs. Conversely, ETF inflows and outflows balance out in hard-currency debt markets. The average spread stands about 345bp. In turn, average local bond yields increased 12bp last week to 6.54%.

Main Market Indicators

G4 Government Bonds	11-Jun-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.6 %	+2	-2	+3
EUR Bunds 10y	0.49%	+8	-7	+7
EUR Bunds 2s10s	110 bp	+6	-5	+4
USD Treasuries 2y	2.53 %	+1	-1	+65
USD Treasuries 10y	2.96 %	+2	-1	+56
USD Treasuries 2s10s	44 bp	+1	+0	-9
GBP Gilt 10y	1.41 %	+11	-4	+22
JPY JGB 10y	0.05 %	0	+0	+0
€ Sovereign Spreads (10y)	11-Jun-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	41 bp	+11	+19	+6
Italy	234 bp	+22	+103	+76
Spain	95 bp	+4	+23	-19
Inflation Break-evens (10y)	11-Jun-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	148 bp	+0	+2	+5
USD TIPS	214 bp	+1	-3	+16
GBP Gilt Index-Linked	309 bp	+1	+1	+3
EUR Credit Indices	11-Jun-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	115 bp	+0	+22	+29
EUR Agencies OAS	53 bp	+2	+15	+15
EUR Securitized - Covered OAS	56 bp	+2	+15	+16
EUR Pan-European High Yield OAS	365 bp	-3	+54	+71
EUR/USD CDS Indices 5y	11-Jun-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	72 bp	+6	+17	+27
iTraxx Crossover	301 bp	+11	+32	+68
CDX IG	66 bp	+2	+7	+17
CDX High Yield	345 bp	+4	+14	+38
Emerging Markets	11-Jun-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	345 bp	+1	+6	+60
Currencies	11-Jun-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.179	+0.61	-1.59	-1.82
GBP/USD	\$1.338	-0.04	-1.52	-1.01
USD/JPY	¥110.09	-0.46	-0.6	+2.36
Commodity Futures	11-Jun-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$76.7	\$1.4	-\$0.3	\$11.6
Gold	\$1 299.7	\$1.1	-\$19.6	-\$3.2
Equity Market Indices	11-Jun-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 789	1.55	2.26	4.33
EuroStoxx 50	3 480	0.31	-2.39	-0.68
CAC 40	5 474	0.02	-1.23	3.04
Nikkei 225	22 804	1.46	0.20	0.17
Shanghai Composite	3 053	-1.24	-3.49	-7.69
VIX - Implied Volatility Index	12.25	-3.85	-3.16	10.96

Source: Bloomberg, Ostrum Asset Management

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