Ostrum ASSET MANAGEMENT

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ECB extends monetary easing

Key Points

- **ECB: prolonged QE, no hike until September 2019**
- **Fed maintains gradual tightening path**
- **Neutral duration stance, flattening bias in the US**
- **Easing in sovereign and credit spreads in the euro area**
- **European equities have given up gains since ECB meeting**

The ECB opted for QE extension until year end and forecasts an interest rate hike in 2019. The decision sent the euro lower to $1.16. Sovereign bond yields, including Italy's BTPs, have eased. Bund yields came in below 0.40%.

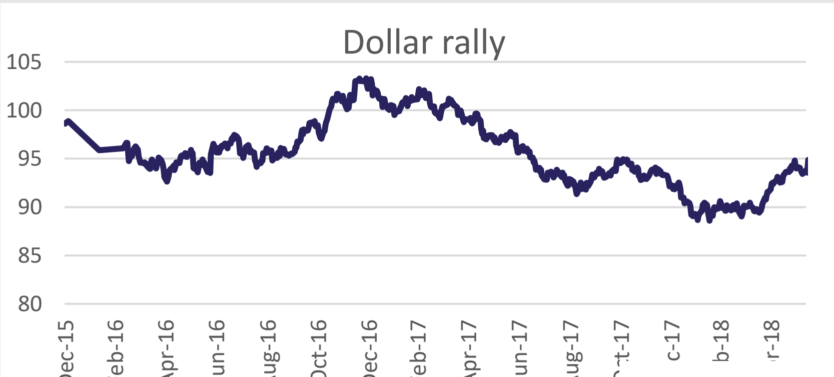
US protectionist measures have been extended, which engineered a strong dollar. IMF has warned against global implications of the trade war championed by Donald Trump. Global long yields have dipped in parallel. T-note yields have hit a 2.90% low whilst Gilts trades near 1.30% ahead of the BoE meeting. The drop in oil prices is traceable to the likely increase in OPEC output.

Despite obstacles to free trade, the S&P index is unchanged this week. US dividend growth is expected to rise. European markets started the week on a weaker footing despite a cheaper euro.

In credit space, spreads (111bp) have fallen by 4bp from a week ago, including significant swap spread tightening and a 10bp weekly downshift in German yields. Synthetic credit remains volatile, even compared with equity indices.

Emerging markets continue to suffer, in particular local-currency bond markets. Brazilian central bank intervention helped stabilize the real.

Chart of the week



Source : Bloomberg, Ostrum AM

The US dollar is on an upward trend since mid-April. Against major currencies, the greenback is up nearly 6% over this period.

The rebound is traceable to steady Fed policy. The Federal Reserve is acting in keeping with its forecasts while other Central Banks including the ECB have opted for a dovish stance lately.

Dollar appreciation also reflects an adjustment after the latest batch of protectionist measures by the Trump Administration.

The art of ECB talk

Mario Draghi announced the end of QE at year-end and a first hike in 2019. The pace of monthly bond purchases will be cut from 30b currently to 15b in the fourth quarter. The end of purchases is conditional to the state of the euro economic cycle. The first hike will occur after the summer of 2019. It will likely be a deposit rate increase which would have little impact on bank funding costs. That said, the commitment to hold rates low until September 2019 has weakened the euro significantly.

The allegedly "unanimous" decision does raise some questions. The ECB increased its inflation forecasts from 1.4%y to 1.7%y this year and next compared with March projections. Hence, the ECB eases policy even as inflation is expected to accelerate on ECB estimates. Also, Mario Draghi seemingly downplayed widespread evidence of a slowdown in the euro area. The downturn in the first half is temporary according to the ECB's President. GDP growth is unchanged for 2019 (1.9%y after a revised 2.1%y this year). Lastly, Italian risk is deemed "local" although the outsized public debt in Italian will weigh on both local and European banking sectors. The Sintra symposium (June 18-20) will give Draghi an opportunity to clarify policy options.

Market reaction is likely a function of investor positioning. The euro initially rose sharply to $1.185 after the release of the decision communiqué before falling back fully three figures during the press conference. Bund yields (0.39% at present) had risen to 0.50% area early on last week before dropping back to about 0.40%. We can justify 0.40% 10y Bund yield but Draghi's speech does seem inconsistent with comments by Peter Praet two days before the meeting.

In this context, it looks appropriate to hold a neutral duration stance. Further rally towards 0.30% is possible on technical grounds. Outperformance from intermediate maturities (5- to 10-year maturities) is sizeable so that 10-30y spreads have increased fully 8bp. Auctions of 30y bonds in Belgium, Germany and Spain may add to steepening pressure. Swap spreads have tightened despite buyback of Bunds. Sovereign spreads have eased, which leads us to raise Italy bond exposure back to neutral. Spain's Bonos and Portugal PGBs are still overweight. Liquidation of peripheral holdings in the past two weeks offer opportunities.

Credit, in keeping with swap spread tightening, was also supported by ECB QE extension. The average spread in the asset class is down 4bp from a week ago to 111bp. Investment flows back into IG bonds also benefit high yield (-12bp). Equities resisted before opening lower on Monday. Eurostoxx 50 has already erased gains since Draghi's speech. Banks, penalised by low rate environment, and commodities show the worst weekly performances. OPEC appears ready to raise output by some 300-600k barrels per day. Brent prices are down $2 from a week ago to 74$. The crude price decline combined with flight-to-safety on T-note and Bund explains the slight underperformance of inflation-linked securities recently.

FOMC: steady as she goes

Fed policy is much more predictable than that of the ECB. Jerome Powell is raising rates as indicated in Fed projections. The Fed Funds target range was increased to 1.75-2% and two more hikes appear likely in 2018. A total of three rate increases in 2019 is the highest probability outcome. Reserve remuneration will increase slightly less than the upper end of the FF range in months to come. Growth will be above-potential until 23020 without significant excess inflation. This scenario is dubious given uncertainties surrounding the impact of global trade restrictions and fiscal stimulus on the economic equilibrium. That being said, current growth is strong. Curve flattening highlights global risks and a tight link to Bunds. The spread oscillates around 250bp. Market levels are consistent with our 2.96% fair value estimate on 10y Treasuries. On technical grounds, the context remains bearish as long as yields stay above 2.69%. The decline in the past week in the wake of the ECB's policy decision and global measures on trade cast doubt on potential upside in yields in the short run. Indeed, 2-10y spreads under 40bp continue to tighten. In long maturity curve segments, stripping activity hints at strong demand from pension funds. The auction of 30y TIPS later this week should attract strong demand. Flows into TIPS bonds have increased despite disappointing breakeven performance so far. We hold a neutral US duration stance and continue to expect a flatter curve.

US equity markets have remained stable. S&P index is still supported by low rates and intense M&A and buyback activity. Energy stocks have corrected to the benefit of utilities. Credit spreads are widening slowly. US investment grade bonds trade near 115bp against Treasuries, the widest spread level in over a year.

Emerging market trend remains subject to tensions in foreign exchange markets (Brazil, Argentina, Mexico) and both political risks and protectionism. Outflows from local-currency sovereign bond funds have continued. Flows have been better balanced as concerns hard-currency emerging debt. The average spread on USD-denominated sovereign debt is about 350bp at present.

Main Market Indicators

G4 Government Bonds	18-Jun-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.62 %	-1	-3	+1
EUR Bunds 10y	0.40%	-10	-18	-3
EUR Bunds 2s10s	101 bp	-8	-15	-4
USD Treasuries 2y	2.55 %	+3	+1	+67
USD Treasuries 10y	2.93 %	-2	-13	+52
USD Treasuries 2s10s	37 bp	-6	-13	-15
GBP Gilt 10y	1.32 %	-8	-18	+13
JPY JGB 10y	0.04 %	-1	-2	-1
€ Sovereign Spreads (10y)	**18-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	33 bp	-9	+7	-3
Italy	216 bp	-19	+51	+57
Spain	86 bp	-9	-1	-28
Inflation Break-evens (10y)	**18-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	147 bp	-1	-2	+4
USD TIPS	213 bp	-1	-4	+15
GBP Gilt Index-Linked	306 bp	-3	-3	0
EUR Credit Indices	**18-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	111 bp	-4	+18	+25
EUR Agencies OAS	47 bp	-6	+9	+9
EUR Securitized - Covered OAS	51 bp	-5	+11	+11
EUR Pan-European High Yield OAS	353 bp	-12	+52	+59
EUR/USD CDS Indices 5y	**18-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	68 bp	-4	+10	+23
iTraxx Crossover	297 bp	-3	+22	+65
CDX IG	61 bp	-4	-1	+11
CDX High Yield	331 bp	-11	-10	+24
Emerging Markets	**18-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	356 bp	+12	+32	+71
Currencies	**18-Jun-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.161	-1.54	-1.41	-3.32
GBP/USD	$1.324	-1.03	-1.69	-2.01
USD/JPY	¥110.46	-0.41	+0.29	+2.02
Commodity Futures	**18-Jun-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$74.5	-$2.0	-$4.0	$9.3
Gold	$1 278.3	-$22.0	-$14.7	-$24.5
Equity Market Indices	**18-Jun-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 769	-0.45	2.08	3.58
EuroStoxx 50	3 467	-0.39	-3.00	-1.06
CAC 40	5 450	-0.43	-2.92	2.60
Nikkei 225	22 680	-0.54	-1.09	-0.37
Shanghai Composite	3 022	-1.48	-5.37	-8.63
VIX - Implied Volatility Index	12.74	2.83	-5.37	15.04

Source: Bloomberg, Ostrum Asset Management

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