MyStratWeekly
Market views and strategy

N° 168 / **July 15th, 2024**

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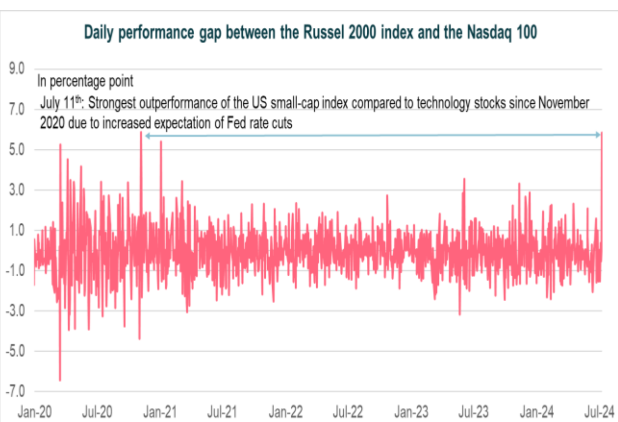
Topic of the week: Towards a decrease in the Fed rates in September
by Aline Goupil-Raguénès,

- The Fed sees the risks regarding the achievement of its price stability and employment objectives as more balanced;
- The job market has normalized, and inflation has significantly moderated, but it still remains above the 2% target followed by the central bank;
- During his semi-annual congressional testimony, Jerome Powell indicated that the Fed needed more "good data" to be more confident in achieving its inflation target;
- The lower-than-expected inflation in June is undeniably one of them;
- This argues for a decrease in the Fed's rates during the September meeting.

Market review: Between the euphoria related to US inflation and political uncertainty
by Aline Goupil-Raguénès

- Sharp drop in bond yields after US inflation;
- The 10-year OAT spread stabilizes around 65 basis points due to political uncertainty;
- The sovereign spreads of peripheral countries are narrowing;
- Significant rotation in US stocks following the US inflation.

Chart of the week



Sources : Bloomberg, Ostrum AM

On July 11th, the US small-cap index (Russell 2000) recorded its strongest outperformance against the Nasdaq index since November 2020 (+5.8 percentage points).
This was the result of increased expectations of a Fed rate cut following the release of lower-than-expected inflation rates. Investors took their profits on technology stocks, which had seen significant gains, and invested in overlooked stocks that were more likely to benefit from Fed rate cuts (such as the construction sector).
As a result, the Russell increased by 3.6% and the Nasdaq decreased by 2.2% for the day.

Figure of the week

0.3

In France, the Olympic Games are expected to have a temporary impact of around 0.3 percentage points on GDP in the third quarter, according to estimates from INSEE. The institute is basing its analysis on the London Olympics Games, which were estimated to have had an impact of between 0.2 and 0.4 percentage points on GDP in the third quarter of 2012.
Source: INSEE

Topic of the week

Towards a decrease in the Fed rates in September

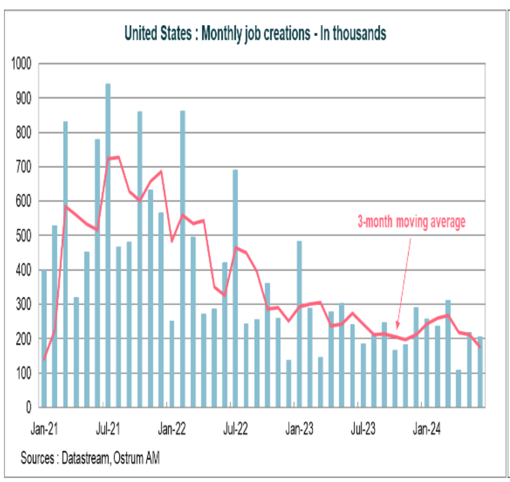
During his semi-annual congressional testimony, Jerome Powell indicated that the Fed needed more "good data" to be more confident in the return of inflation to its target and to be able to lower its rates. The inflation figures published on Thursday are undeniably "good data" that should lead the Fed to make its monetary policy less restrictive at the September 18 meeting.

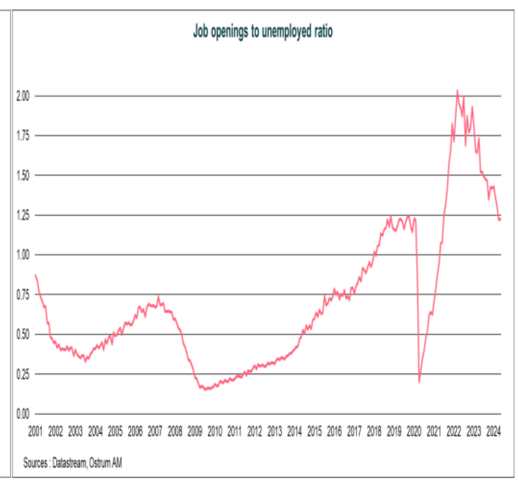
The Fed sees the risks as more balanced

During his two appearances before Congress on July 9th and 10th, Jerome Powell stated that the Fed had made considerable progress towards achieving the 2% inflation target and that the labor market had slowed down while remaining strong. The U.S. central bank thus believes that the risks are becoming more balanced in achieving its price stability (2% inflation target) and maximum employment objectives.

The job market has normalized

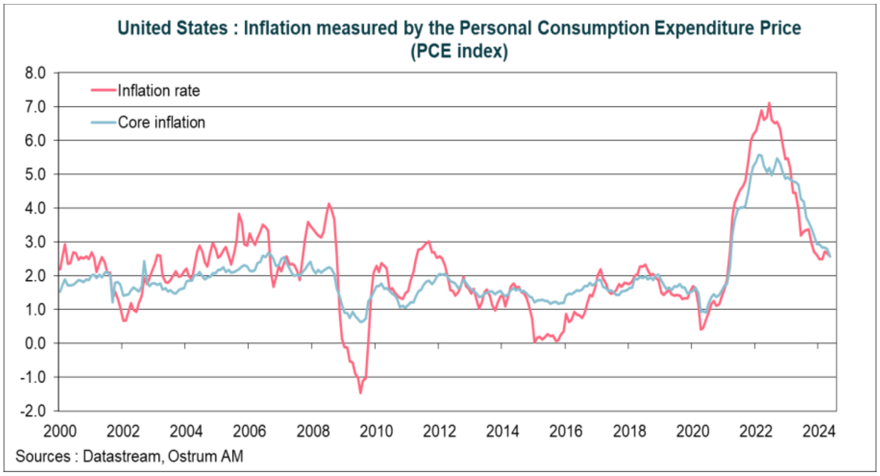
Jerome Powell rightly points out that the conditions in the labor market have returned to pre-Covid-19 crisis levels. The job market is robust without being overheated, as evidenced by the gradual increase in the unemployment rate to 4.1% in June, which remains at low levels. Job creation has been slowing down since March, in line with the moderation of growth. The demand for labor is no longer excessive, as evidenced by the decrease in the job openings-to-unemployed ratio, returning to pre-pandemic levels.





Inflation (PCE index) has significantly slowed down but still remains above the target

The inflation measured by the Personal Consumption Expenditures Price (the index followed by the Fed) has significantly moderated compared to the peak reached in 2022. It returned to 2.6% in May, compared to a 40-year high of 7.1% in June 2022. The core inflation (which excludes volatile elements of energy and food) has also significantly slowed down, returning to 2.6% in May, compared to a peak of 5.6% in 2022. This reflected the impact of the strong post-Covid demand recovery in a context of limited supply, and then the rise in energy prices. The dissipation of these effects has allowed inflation to return to 2.6%. However, it still remains above the 2% target followed by the Fed.



The Fed needs more "good data" to be more confident in achieving the inflation target

That is why Jerome Powell has signaled that the Fed needs more "good data" in order to be more confident in achieving the 2% inflation target. Jerome Powell also indicates that high inflation is not the only risk facing the economy. There is also the risk of reducing the degree of monetary policy restraint too late or too little, which would weigh on growth and employment. Conversely, reducing the degree of monetary policy restraint too early or too quickly risks halting or reversing progress made in inflation. The Fed thus determines monetary policy based on the published data and their impact in achieving its objectives.

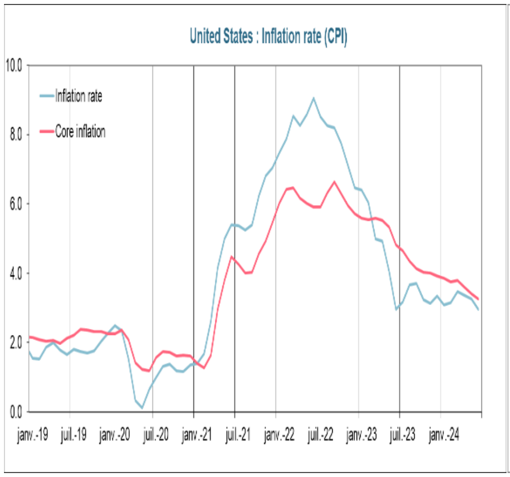
Lower-than-expected inflation in June

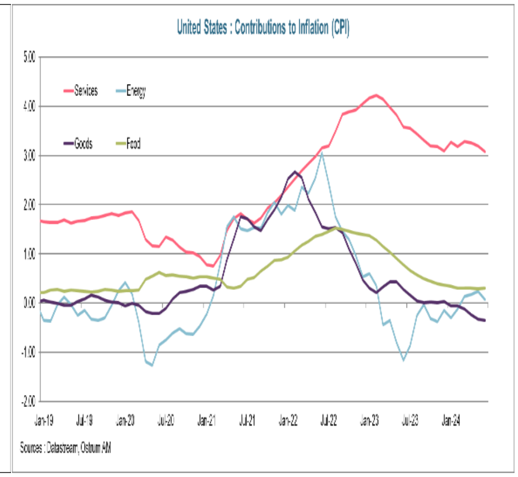
The inflation in June (CPI) is likely to reassure the Fed

Inflation, measured by the Consumer Price Index (CPI), decreased by 0.1% in the month of June, while the consensus expected an increase of 0.1%. It had remained stable in the month of May. This monthly decline is notably linked to energy prices (-2%), for the second consecutive month, and used car prices (-1.5%), offsetting the rise in rental prices. On an annual basis, inflation has slowed for the third consecutive month: 3% in June (compared to the consensus expectation of 3.1%), after 3.3% in May, 3.4% in April, and 3.5% in March 2024.

Core inflation is at its lowest level since April 2021

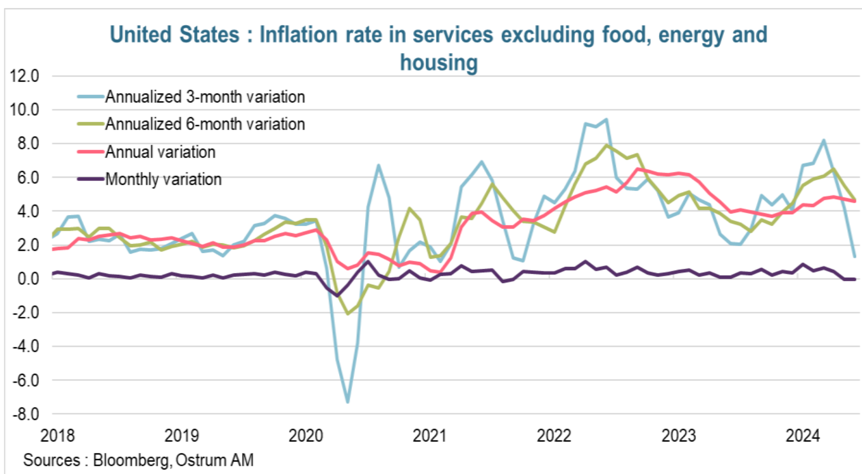
Core inflation also came in lower than expected: 0.1% for the month, compared to the expected 0.2%, after 0.2% in May. On an annual basis, it has slowed to 3.3% (compared to the expected 3.4%), from 3.4% in May, 3.6% in April, and 3.8% in March. This marks the third consecutive month of deceleration and the lowest core inflation rate since April 2021.





Slowdown of inflation in services excluding food, energy and housing

The Fed closely monitors inflation in services excluding food, energy and housing (the super core index) to better understand domestic pressures, particularly those stemming from the labor market. Super core inflation remained almost stable in May and June after accelerating in the first quarter. It has significantly slowed in the three-month variation: 1.3%, compared to 4.2% in May, 6.3% in April, and 8.2% in March. On an annual basis, super core inflation slowed to 4.6% in June, compared to 4.7% and 4.9% in the two previous months. It remains nevertheless high.



This tends to show that the inflation acceleration in the first quarter was temporary

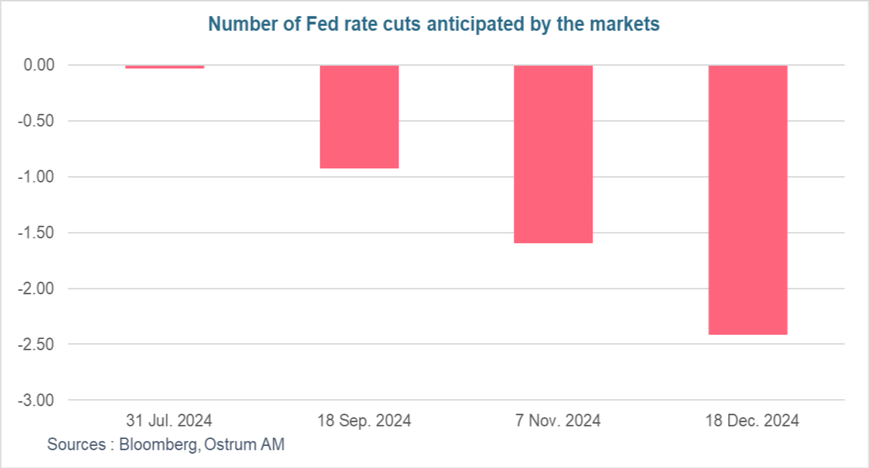
The lower-than-expected inflation in June tends to show that the sharp acceleration of inflation in the first quarter was temporary.

This has been reinforced by the publication of the core Producer Price Index, which remained stable in June, while an increase of 0.2% was expected. The University of Michigan's consumer sentiment survey was also reassuring. Household expectations for inflation in 1 year and in 5 years have slightly decreased, according to preliminary figures, returning to 2.9% in July, down from 3% in June.

A decrease in the Fed's rates in September

Increase in the markets' expectations of a Fed rate cut

The lower-than-expected inflation figures clearly form part of the "good data" referenced by Jerome Powell during his previous two testimonies before Congress. This has strengthened expectations for a Fed rate cut in September. The markets now anticipate this almost entirely. They expect a little more than a second rate cut by the end of the year. This will help make monetary policy slightly less restrictive, as rates are expected to return to [4.75% - 5%] by the end of the year, compared to [5.25% - 5.50%] since July 2023.



The Fed is already making its monetary policy less restrictive through its balance sheet

The Fed has already begun to make its monetary policy less restrictive by reducing the pace of contraction of its balance sheet since June 1st. The ceiling for maturing Treasury securities not being reinvested has been lowered to $25 billion from the previous $60 billion. The ceiling for mortgage-backed securities has been maintained at $35 billion, and beyond this threshold the proceeds will be reinvested in Treasury securities.

Conclusion

The first phase of moderation in inflation was rapid, as it resulted from the end of the effects related to the Covid-19 crisis: strong demand in a context of insufficient supply and disruptions in supply chains. Now that these effects have nearly dissipated, inflation is struggling to further converge towards the Fed's 2% target due to domestic pressures. The inflation in June suggests that the first-quarter acceleration was temporary. At the same time, the job market has normalized to pre-Covid levels and the US growth is slowing. This suggests a first rate cut by the Fed at the September 18 meeting, followed by a second cut on December 18th.

Aline Goupil-Raguénès

Market review

Between the euphoria related to US inflation and political uncertainty

Sovereign bond markets reacted positively to the lower-than-expected US CPI in a context of political uncertainty in France and the United States.

The US inflation, reported last Thursday, is undeniably part of the "good data" referenced by Jerome Powell earlier in the week, in order for the Fed to be more confident in lowering its rates. Inflation decreased by 0.1% in June, while the consensus expected an increase of 0.1%. On an annual basis, it slowed to 3%. Core inflation is also lower than expected: 3.3%, the lowest since April 2021. This tends to show that the inflation acceleration observed in the first quarter was temporary. Expectations for a Fed rate cut in September have thus intensified. Short-term rates, which are more sensitive to monetary policy expectations, have decreased significantly more than long-term rates, leading to a steepening of the yield curve. The US 2-year yield decreased by 15 basis points over the week (13 basis points after the CPI release) to close at 4.45%, and the 10-year yield decreased by 10 basis points to finish at 4.18%. The 10-year yield is at its lowest level since March, despite a moderately successful 30-year bond auction. This significant decrease in US yields has spread to European yields to a lesser extent. The German 2-year yield decreased by 7 basis points to 2.82%, and the 10-year yield decreased by 6 basis points to 2.5%.

The political uncertainty remains. In the United States, calls for Joe Biden to withdraw from the race for the White House are increasing. This comes as Donald Trump was the target of an assassination attempt during a rally in Pennsylvania and could be strengthened by it. In France, no party or bloc has an absolute majority following the second round of early legislative elections. The President wishes to take time before appointing a new Prime Minister and has encouraged parties to form a broad republican coalition. In this context of uncertainty, rating agencies have expressed concerns about France's ability to make the necessary adjustments to reduce its public deficit, which is the second largest in the Eurozone after Italy (5.5% of GDP in 2023). The monthly business survey conducted by the Bank of France, carried out between June 26 and July 3, revealed a sharp increase in the uncertainty index, reaching its highest level since 2022, during the energy crisis. This raises concerns about a cautious approach from business leaders in terms of investments and hiring due to political uncertainty. In this context, the spread of the 10-year OAT has stabilized at 65 basis points, higher than the level that prevailed before the announcement of the dissolution of the National Assembly (48 basis points). The spreads of peripheral countries have narrowed to levels close to or lower than those during the French political crisis: -8 basis points for Greece and Italy, -3 basis points for Portugal, and -2 basis points for Spain. Inflation breakeven rates have decreased over the week (-4 and -5 basis points in the Eurozone and the United States) in the wake of the US inflation and the decrease in oil prices. The spreads of euro IG credit remained generally stable. The week was also marked by a depreciation of the dollar due to the increased expectations of a Fed rate cut. The euro thus closed at $1.09. The strong appreciation of the yen against the dollar (over 2%) following the release of the US CPI raises suspicions of a new intervention by the BoJ. Stock markets registered gains: +0.9% for the S&P, with a strong rotation on Thursday, as investors shifted away from large tech companies towards small businesses. The Euro Stoxx 50 rose by 1.3% and the CAC 40 by 0.6%. It continues to underperform the Euro Stoxx 50.

Aline Goupil-Raguénès

Main market indicators

G4 Government Bonds	15-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.81%	-9	+5	+41
EUR Bunds 10y	2.48%	-6	+12	+46
EUR Bunds 2s10s	-33.2bp	+4	+7	+5
USD Treasuries 2y	4.46%	-17	-25	+21
USD Treasuries 10y	4.23%	-5	+1	+35
USD Treasuries 2s10s	-23bp	+12	+26	+14
GBP Gilt 10y	4.11%	+0	+6	+58
JPY JGB 10y	1.07%	-3	-5	-31
€ Sovereign Spreads (10y)	**15-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	65bp	+2	-15	+11
Italy	128bp	-7	-29	-39
Spain	76bp	+0	-16	-20
Inflation Break-evens (10y)	**15-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.2%	-3	-3	+7
USD 10y Inflation Swap	2.51%	-1	+2	+10
GBP 10y Inflation Swap	3.63%	+1	-3	+10
EUR Credit Indices	**15-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	109bp	+1	-3	-29
EUR Agencies OAS	62bp	+0	+0	-8
EUR Securitized - Covered OAS	62bp	+0	+0	-17
EUR Pan-European High Yield OAS	360bp	+2	+8	-39
EUR/USD CDS Indices 5y	**15-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	52bp	-1	-12	-7
iTraxx Crossover	286bp	-3	-44	-28
CDX IG	48bp	-1	-5	-8
CDX High Yield	322bp	-8	-23	-35
Emerging Markets	**15-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	389bp	-3	+3	+5
Currencies	**15-Jul-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.092	0.850	1.696	-1.1
GBP/USD	$1.299	1.437	2.251	2.0
USD/JPY	JPY 158	1.830	-0.127	-10.7
Commodity Futures	**15-Jul-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$84.6	-$1.1	$2.6	11.5
Gold	$2 418.8	$59.7	$99.7	17.2
Equity Market Indices	**15-Jul-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 638	1.17	3.80	18.2
EuroStoxx 50	4 993	0.47	3.18	10.4
CAC 40	7 641	0.18	1.84	1.3
Nikkei 225	41 191	0.68	6.12	23.1
Shanghai Composite	2 974	1.76	-1.93	0.0
VIX - Implied Volatility Index	12.91	4.37	1.97	3.7

Source: Bloomberg, Ostrum AM

Additional notes

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