Ostrum ASSET MANAGEMENT

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Market views and strategy

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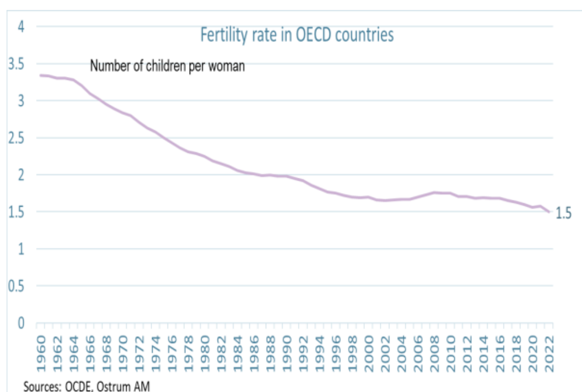
Topic of the week: G4 FX: something's got to give
by Axel Botte,

- The dollar remains the cornerstone of financial markets and a source of stability despite twin deficits and upcoming election deadlines;
- The yen remains significantly undervalued, burdened by very negative carry trades and an ongoing expansionary monetary policy that limits interventions in the foreign exchange market;
- The renminbi is facing external pressures through European and American tariff policies as well as weak domestic demand, which forces the PBoC to ease its policy. The specter of the 2015 summer devaluation resurfaces;
- Political risk weighs on the euro, reminiscent of previous crises. The ECB has the means to limit contagion risks, but the single currency will remain under pressure.

Market review: A precarious calm in the markets
by Axel Botte

- AFT conducts its auctions, relaxation in sovereign spreads;
- Surveys decline under the weight of the French political situation;
- Mixed publications in the United States and China;
- European stocks rebound by 2% for the week.

Chart of the week



According to a new OECD report, the fertility rate in developed countries has halved since 1960, dropping from 3.3 children per woman to just 1.5 in 2022. This rate has even fallen to 1.2 in Spain and Italy, and to 0.7 in Korea. This reflects, in particular, the fact that the average age for women to have a child has increased (from 28.5 years in 2000 to 30.9 in 2022) and that the number of childless women has risen. The fertility rate is thus well below the population replacement level of 2.1. This poses a risk of demographic decline, resulting in a decrease in the working-age population and an aging population that could make it even more challenging for governments to finance retirement systems, healthcare services and services for the elderly.

Figure of the week

12.7

This is the amount borrowed by the French Treasury in billions of euros at nominal and inflation-linked bond sales last week. This is the high-end of the indicated range by the AFT, which signals strong investor demand.

Source: Bloomberg

Topic of the week

G4 FX: something's got to give

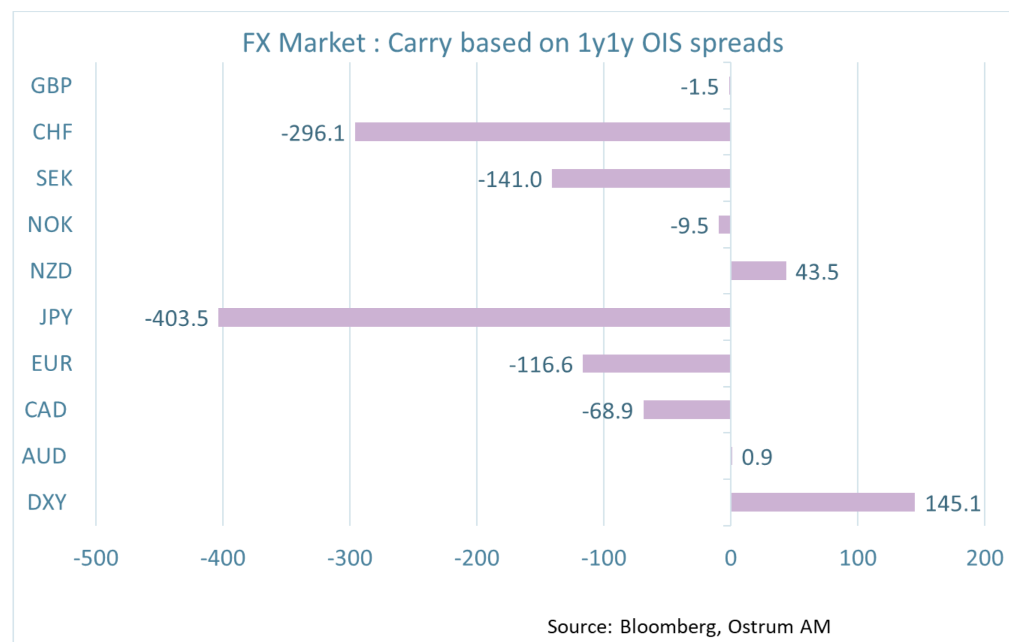
The foreign exchange market is waking up to heightened political risk in Europe, US and European protectionism, and divergence in central bank policies. Prepare for tectonic shifts, hope for the best.

King dollar reigns

The dollar remains the key anchor in global financial markets.

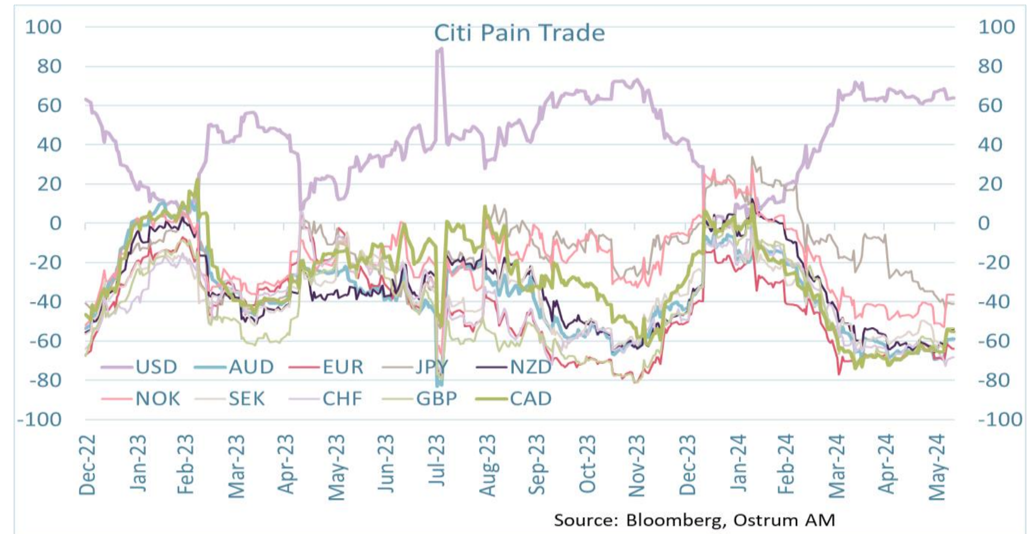
The US dollar is the most important relative price in global financial markets. Despite the increasing use of the Chinese yuan for trade settlement, dollar domination is unchallenged in financial markets. Strong growth and a leading equity market have overshadowed the US twin deficits.

The supply of US dollars is controlled by the Federal reserve. The Fed's current quantitative tightening (i.e., a reduction in the supply of dollars) provides support to the greenback. Furthermore, the interest rate backdrop is supportive. The US dollar offers superior carry within developed markets. In the chart below, we measure carry on the DXY basket as a 1-Yr forward 1-Yr OIS spread to take into account market expectations for global policy rates. The carry on the DXY basket (heavily influenced by the euro) is now 145 bps. The FX market complex is another way to gauge carry on currencies. Indeed, deposit rates on the USD implied stand at 5.56% on an overnight basis and still above 5.30% on a 1-Yr term even as the Fed expect to start cutting interest rates later this year. In other words,



Current positioning in FX markets look particularly one-sided with a dominant long dollar exposure. The Citi FX Positioning Alert Indicators infer the positioning of active currency traders from relationships between exchange rates and currency managers' returns. A positive

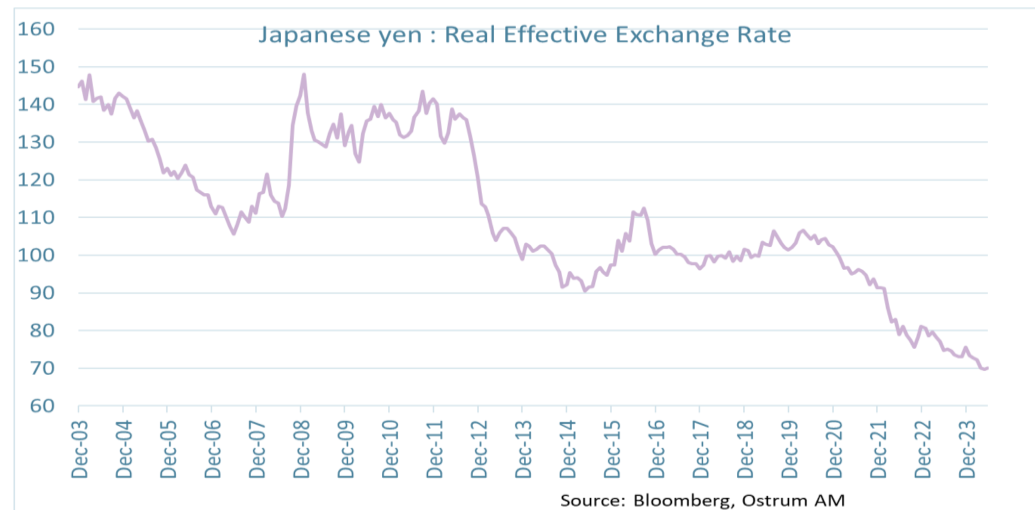
(respectively negative) reading suggests that currency traders have been net long (short) the currency. In the chart below, US dollar long positioning appears to dwarf all other trades. Positioning is indeed similar across all currency pairs. This is a binary FX market. That said, CFTC positioning data offers a more nuanced picture but leveraged players hold on to a long dollar stance.



A soft floor on the yen

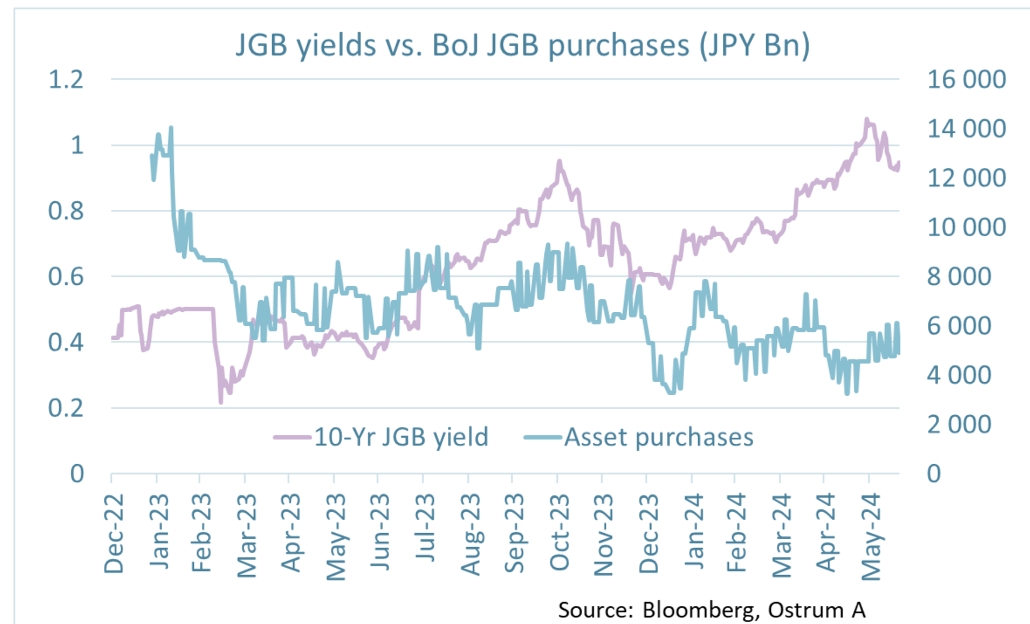
Finding a floor on the yen

Yen weakness has gone far beyond what we and the consensus had expected. The real effective exchange rate of the yen still stands about 25-30% below the long-run average. Deep undervaluation underlies a bullish consensus on the yen that has been constantly caught off-guard by a slow-moving Bank of Japan. The shock to the terms of trade as energy prices spiked in 2022 was never corrected by monetary tightening. Meanwhile, other central banks effectively raised interest rates and pursued quantitative tightening. The BoJ's policy inertia turned the Japanese yen into a deep funding currency for global carry trades. The resulting selling pressure was such that the yen has lost its status as a global safe haven.



A line in the sand has now been drawn around 162 on the dollar-yen exchange rate when the MoF and the BoJ decided to intervene by buying as much as 9 trillion yen (selling about 60 billion dollars) to halt the downward spiral in the Japanese currency. However, market intervention is always perilous all the more so when there is no coordination with foreign institutions, chief among them the US Treasury department. Indeed, Treasury Secretary Janet Yellen made clear that she was unaware of intervention beforehand. There is thus no guarantee that markets won't test the upper bound at 162 again. The other issue lies with the continuation of large-scale asset purchases by the Bank of Japan. Quantitative easing adds to yen supply to the tune of 6 trillion yen a month. In other words, JGB purchases have quickly undone any short-term relief from foreign exchange intervention.

BoJ must end QE to enforce a floor on the yen



Source: Bloomberg, Ostrum A

There could be light at the end of the tunnel for the Japanese yen. 10-Yr JGB yields have climbed to 1% with short-term rates about 0%. The carry on JGB holdings is now much more attractive to Japanese institutions than foreign bonds where inverted yield curves mean that hedging of foreign exchange is quite costly. Outbound investments should diminish.

Yuan : remember August 2015

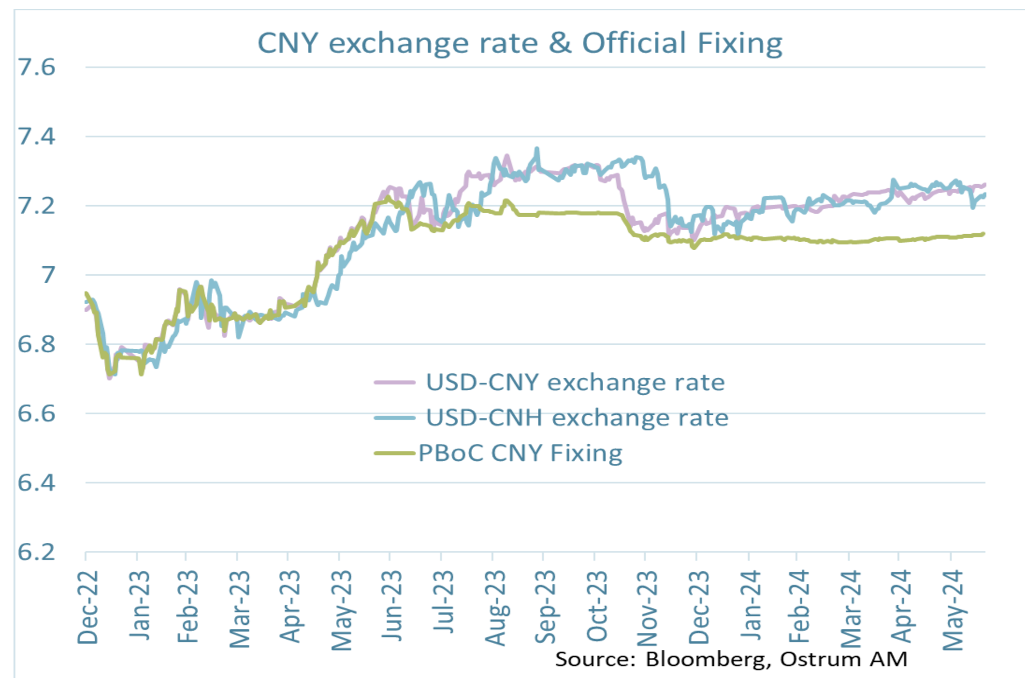
In keeping with the yen's depreciation, the Chinese yuan has weakened against the US dollar to near multi-year lows (around 7.25). Capital outflows from China (estimated from changes in reserves and the trade balance) are anywhere between \$50 to \$100 billion dollars a month. The yuan is trading at the lower bound of its target range (2% below the official fixing rate of 7.11 on June 20th). The PBoC must keep it afloat by selling US Treasuries. But China's official holdings of US government bonds have shrunk to \$767 billion in May from over \$1.1 trillion three years ago. That leaves China with less firepower to defend the value of Renminbi against the dollar. The Chinese currency is nevertheless more stable against the currencies of its trading partners.

There are both domestic and external reasons for the renminbi weakness. Domestically,

inflation is close to zero amid subdued household spending. Furthermore, the persistent drag from the downturn in real estate ensures that the PBoC will keep easing. Policy rates at 2.50% have further to fall and the PBoC is now considering changes to its operational framework including direct intervention in secondary bond markets, possibly akin to an asset purchase program or yield curve control.

On the external side, the US and Europe have raised trade barriers in the form of tariffs. This is a signal that China's EV production capacity and technological advantage pose an existential threat to European and US carmakers. Chinese companies have also built an advantage in many sectors linked to the energy transition. China's tacit support to Russia will only exacerbate trade tensions with new sanctions including tariffs and trade restrictions.

The end game could be a CNY devaluation if the export-driven Chinese growth eventually slows below 5%. There is a precedent in August 2015. The PBoC decided to lower the CNY fixing by 3% in a surprise announcement. The devaluation was a disruptive event for equity markets so that then Fed Chair Yellen postponed a long-awaited rate hike to December 2015.



The euro beaten down by politics

The single currency has often been subject to extreme political risk. The sovereign and banking crises in the early 2010s raised the question of a breakup of the currency union. In 2018, the unexpected coalition outcome from the Italian general election weighed on the euro. The risk ahead is not that of a breakup of EMU but is nevertheless significant. The snap election called by President Emmanuel Macron in France sparked a new bout of volatility in the foreign exchange market. The euro-dollar pair plunged briefly below the $1.07 threshold within days following the announcement. Besides the US greenback, the Swiss franc has often been the European safe haven currency of choice. That remains the case today. Resulting upward

pressure on the franc is likely to persist even as the SNB just cut interest rates for the second time in 2024.

The fate of the euro will ultimately depend on the ECB's policy response, should tensions persist in the sovereign bond market. The first line of defense lies with the flexibility of PEPP reinvestments (in terms of timing, size, and country allocation) although the ECB intends to reinvest less of the proceeds from July. The activation of the Transmission Protection Instrument (TPI) to mitigate contagion across bond markets could help to contain volatility but would be akin to temporary quantitative easing and contradict current policies aiming at balance sheet contraction. In any case, policy easing is likely to keep a lid on the euro.

Conclusion

Something has to give in currency markets. The strong US dollar offers high carry and safety value but the US economy exhibits imbalances in the form twin deficits of significant magnitude. The Japanese yen is extremely weak relative to economic fundamentals. The slow-moving BoJ is unwilling or unable to tighten enough to put a hard floor on the Japanese yen even in the context of near-target inflation. As regards the Renminbi, the high dependence on exports now puts Chinese growth at risk. Capital outflows and protectionism out of the US and Europe may force a CNY devaluation as the PBoC will keep easing monetary policy for domestic reasons. The euro is faced with renewed political uncertainty fanning outflows from European markets. The ECB response will be key. All the above points to continued relative strength of the dollar until something breaks.

Axel Botte

Market review

A precarious calm in the markets

A week of calm in the markets despite political uncertainty affecting business confidence in France and Europe, and signals of economic slowdown in the United States.

The OAT spread (77 bps) continues to command the attention of market participants ahead of the legislative elections on June 30th and July 7th. Contagion risk has been contained and tensions surrounding European debts have abated. The partial alleviation of last week's pressures is traceable to easing swap spreads. The European credit market has reacted moderately to the sovereign debt tensions, demonstrating resilience without excessive fluctuations. Despite a second rate cut by the Swiss National Bank, the Swiss Franc remains an attractive hedge in the context of the French political risk. Gold has gained 1% over the week, reflecting investor interest in safe-haven assets. The yield on US T-Notes hovers around 4.25%, influenced by a less buoyant housing construction outlook. Inflation expectations have risen following the increase in Brent prices to $85 per barrel. The US dollar, along with US equities, represents a safe- investment amidst the prevailing market conditions.

The economic surveys are beginning to incorporate the political uncertainty in France. The PMI is declining and INSEE's survey is flat at best. Consequently, the economic recovery in the Eurozone may slow down in the second quarter, following the surprising rebound between January and March. Meanwhile, a change in political leadership is on the horizon in the United Kingdom, at a time when consumer confidence and spending improve. In the United States, the second quarter growth is expected to be around 2%, but the housing sector is facing significant headwinds. The plummeting confidence of homebuilders (NAHB at 47) is accompanied by a further decline in housing starts, which fell below the 1.3 million mark in May. The shortage of available housing will continue to fuel the rise in prices, just as the Fed wants to initiate a cycle of interest rate cuts. Chinese reports indicate a slight rebalancing of growth, with retail sales accelerating by 3.7% year-on-year, while industrial production slowed to 5.6% in May. The housing situation remains dire, as the decline in property prices intensifies and residential investment contracts steadily at a rate of 10% annually over the past 18 months.

As regards financial markets, the bi-weekly auction of OATs held particular significance this week. The AFT borrowed the maximum amount indicated, totaling 10.5 billion euros in medium-term nominal securities and over 2 billion euros in index-linked securities. The next auctions are scheduled to take place between the two rounds of the legislative elections. French spreads stabilized just under 80 basis points. A lull in tensions is evident in swap spreads, as well as in other sovereigns and, to a lesser extent, in credit markets. With Treasuries hovering near 4.25% at the 10-year mark, they continue to serve as a safe haven, particularly as recent publications depict a less robust growth outlook. However, the rise in crude oil prices has reignited inflation expectations, leading to a 10 basis points increase in the 2-year swap rate. Credit spreads have widened moderately as a result of the widening movement in swap spreads. The knee-jerk compression of high-yield spreads relative to investment-grade spreads is now fading, signaling a calmer market environment, as evidenced by the receding volatility in European equities. The Euro Stoxx 50 gained 2% for the week, narrowing some of its gap with the S&P 500 (+1%), once again driven by its mega-cap technology stocks. European financials also saw a 3.4% uptick.

Axel Botte

Main market indicators

G4 Government Bonds	24-Jun-24	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	2.79 %	-2	-30	+39
EUR Bunds 10y	2.40%	-1	-18	+38
EUR Bunds 2s10s	-39 bp	+1	+12	-1
USD Treasuries 2y	4.73 %	-4	-22	+48
USD Treasuries 10y	4.25 %	-4	-22	+37
USD Treasuries 2s10s	-48 bp	+0	0	-11
GBP Gilt 10y	4.06 %	-5	-20	+53
JPY JGB 10y	1 %	+6	-1	+38
€ Sovereign Spreads (10y)	24-Jun-24	-1wk (bp)	-1m (bp)	YTD (bp)
France	78 bp	-1	+31	+24
Italy	150 bp	-3	+20	-17
Spain	86 bp	-4	+9	-11
Inflation Break-evens (10y)	24-Jun-24	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi	202 bp	-8	-15	-
USD TIPS	224 bp	+1	-9	+6
GBP Gilt Index-Linked	359 bp	-3	-14	+11
EUR Credit Indices	24-Jun-24	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	121 bp	-1	+11	-17
EUR Agencies OAS	72 bp	-1	+15	+2
EUR Securitized - Covered OAS	69 bp	-1	+9	-10
EUR Pan-European High Yield OAS	371 bp	-7	+28	-28
EUR/USD CDS Indices 5y	24-Jun-24	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	61 bp	-2	+10	+3
iTraxx Crossover	322 bp	-7	+33	+9
CDX IG	53 bp	0	+4	-3
CDX High Yield	342 bp	-2	+14	-14
Emerging Markets	24-Jun-24	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	395 bp	+0	+30	+11
Currencies	24-Jun-24	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.072	-0.08	-1.21	-2.93
GBP/USD	$1.266	-0.27	-0.59	-0.54
USD/JPY	¥159.76	-1.23	-1.73	-11.72
Commodity Futures	24-Jun-24	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$85.4	$1.2	$3.6	$9.3
Gold	$2 329.6	$12.6	-$4.2	$266.7
Equity Market Indices	24-Jun-24	-1wk (%)	-1m (%)	YTD (%)
S&P 500	5 465	0.57	3.01	14.57
EuroStoxx 50	4 939	1.20	-1.91	9.24
CAC 40	7 670	1.30	-5.25	1.68
Nikkei 225	38 805	1.84	0.41	15.96
Shanghai Composite	2 963	-1.75	-4.07	-0.40
VIX - Implied Volatility Index	13.76	8.69	15.34	10.52

Source: Bloomberg, Ostrum Asset Management

Additional notes

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