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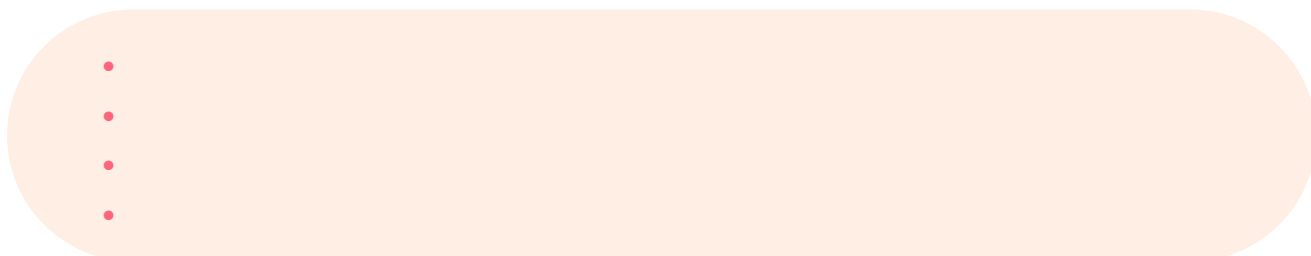


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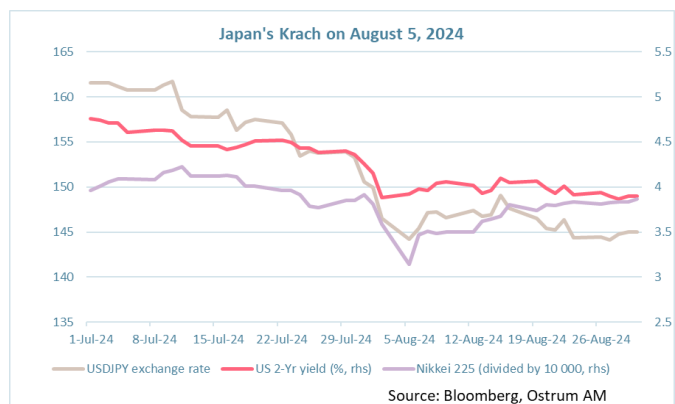
● **Topic of the week: Summer highlights**
by Axel Botte

- The markets were highly volatile due to the rise in interest rates in Japan and the resurgence of, perhaps exaggerated, fears of an imminent recession in the United States.
- The initial crash, with a 12% drop in the Nikkei on August 5th, quickly subsided without causing significant collateral damage. Short yen positions unwinding accompanied the BoJ's decision and continue to be a source of volatility. The BoJ will proceed cautiously with further rate hikes.
- The message from the Fed at Jackson Hole unequivocally foreshadows monetary easing in the coming months. Other central banks are accelerating their pace, such as the Riksbank. The RBNZ also surprised the markets by making an initial rate cut.
- The volatility of interest rates and exchange rates did not prevent a strong rebound in equities to the 2024 highs and a new tightening of credit spreads. Swap spreads and sovereign spreads have decreased. The iTraxx Crossover has significantly dropped below 300 basis points.

● **Market review: The review will resume next week**
by Axel Botte



● **Chart of the week**



A new cross-market equilibrium. The gradual appreciation of the yen throughout the month of July accelerated with the decision of the BoJ to raise its rate. At the same time, an accommodative Fed and disappointing employment statistics in the United States amplified downward pressure on the Japanese stock market, which plummeted by 12% on August 5th. The new equilibrium for the yen is around 145 to the dollar, compared to 155-160 previously. The stabilization of equities is also traceable to the significant adjustment in the US 2-year yield, confirming the imminent monetary easing in the United States. The 2-year yield is now hovering around 3.90%, compared to approximately 4.40% before the Japanese crash.

● **Figure of the week**

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The number of women in governor roles rose to 29 this year from 23 last year, though that left the share of female leaders at just 16 percent of the world's 185 central banks.

Source: Official Monetary and Financial Institutions Forum

- **Topic of the week**

Summer highlights

The financial markets have reacted strongly to the Bank of Japan's rate hike. The unwinding of speculative short yen positions has caused market turmoil, especially as the slowdown in US job creation has heightened recession fears. In contrast to the Bank of Japan, most G10 central banks have begun a monetary easing cycle, which the Fed is expected to join in September. Jerome Powell's message at Jackson Hole leaves little doubt about this. After the shock of a 12% one-day drawdown on the Nikkei on August 5, risky assets have rebounded. US stocks are near their 2024 highs, thanks to the decline in long-term interest rates. The T-note is hovering around 3.80%. In the Euro area, the Bund is trading about 2.25%. The narrowing of sovereign and credit spreads has also resumed.

Beliefs and reality

The specter of a US recession resurfaces

The financial markets and Wall Street banks are always eager to forecast whatever economic environment that would most likely lead to monetary easing. The summer of 2024 was no exception. Stock market turbulence following the Bank of Japan's rate hike and the mediocre US labor market statistics have generated unfounded expectations of an imminent Fed rate cut, even before the September 18 FOMC meeting.

The 114k job creations recorded in July were indeed accompanied by a rise in the unemployment rate to 4.3%, a warning sign for believers in the Sahm rule. This empirical rule, which indicates an imminent recession in the United States, seems to be contradicted by the strength of retail sales, the stability in jobless claims, or service sector surveys. US growth is likely to remain close to 2% in the third quarter.

In addition to the increase in unemployment (likely exacerbated in July by Hurricane Beryl), revisions to employment figures have altered the perception of the labor market. Monthly figures are subject to caution due to the dubious estimate of business creations and destructions on a month-to-month basis. The quarterly BLS survey (QCEW) covering the period from April 2023 to March 2024 retrospectively erased some 818k jobs from the non-farm payrolls. Would US monetary policy have been very different from the prolonged status quo if central bankers had access to this real-time data? Would the last hike in July 2023 have taken place? No one knows, but the maximum employment objective would have carried more weight in the FOMC's deliberations alongside price stability.

Monetary policy: the need to reaffirm a direction

The markets are always clamoring for more rate cuts.

The Fed generally proceeds in a linear and readable manner, in contrast to the fast-changing expectations of the financial markets' participants. For this reason, Jerome Powell's speech at Jackson Hole has helped anchor the trajectory of the Fed funds in keeping with the economic reality. Financial conditions have improved over the course of the year despite the volatility observed in the middle of the summer. US long-term rates

have receded, credit spreads have tightened in line with the rebound in equity markets, and banks appear less inclined to tighten credit conditions, even as delinquencies rise (for instance on credit card balances). Therefore, the upcoming monetary easing seems to primarily respond to the decline in inflation. US inflation is below the 3% threshold.

GDP growth in the euro area stood at 0.3% in the second quarter. However, activity within the monetary union remains uneven, and surveys are dipping. The effect of the Olympics will boost French growth between July and September, while the German economy is contracting. Inflation at 2.6% in July remains above the ECB's target, but the Frankfurt institution has begun its easing cycle. The moderation of wage increases resulting from collective negotiations seems to validate the scenario of a return to 2% inflation in 2025. Other central banks have also taken preemptive action. The Swedish Riksbank has lowered its rate to 3.5% and projects 2 to 3 more cuts by the end of the year.

Downunder, the RBA and the RBNZ seem to be at odds. The former maintains a restrictive stance, considering inflation remains close to 4%. The RBA has little room to adjust its current key rate of 4.35%. In contrast, the RBNZ surprised markets by cutting its policy rate by 25 basis points. The New Zealand bank believes the economy fell into a recession in Q2. The rise in unemployment and the slowdown in immigration justify the rate easing to 5.25%, especially as inflation is receding.

The unwinding of carry trades on the yen has caused upheaval

Unwinding of the yen carry trade, a short-lived upheaval.

The Bank of Japan triggered a stock market storm by raising its key rate by 15 basis points. Monthly purchases of JGBs are expected to halve in the first half of 2025. However, the Nikkei crash on Monday, August 5th (-12% in one trading session) occurred a few days after the BoJ meeting on July 31st and seems more linked to the US employment report. Nevertheless, these violent position unwindings in the middle of the summer remind us of the scale of positions in risky assets financed in yen. Speculative short positions on dollar-yen futures have since been halved according to CFTC data, but these indicators only reflect a tiny portion of the volumes traded in the foreign exchange market. The Mexican peso is also a victim of these unwinds. Beyond this knee-jerk market reaction, the allure of the carry trade has not really diminished, even though the Fed and consequently most central banks will contribute to narrowing interest rate differentials. The BoJ initially sought to reassure market participants as regards the timing of future rate moves, but inflation close to 2% seems to point to new increases in the fourth quarter.

In this context, the downward pressure on the Chinese renminbi has eased. The dollar-yuan exchange rate is moving in line with the official fixing, whereas it had regularly flirted with its upper limit. However, the direction of Chinese monetary policy has not changed, as the growth obstacles appear significant. Capital outflows require monetary easing and raise the risk of devaluation. Another collateral effect is the rise of the euro beyond \$1.11. This unexpected rebound of the single currency mainly reflects an adjustment of the U.S. dollar. The British pound also surpasses the \$1.30 threshold, even as the BoE made its first rate cut in early August. The premium on the US greenback has deflated in favor of other currencies, including the Swiss franc, whose status as a safe haven is beyond question. Thus, the balance of risks in the the foreign exchange market has been disrupted after the BoJ's decision, but much remains to be done to bring the yen back in line with its fundamental value (likely 120-130 yen per dollar).

Harris takes over.

Kamala Harris enters the Presidential race

On the political front, Joe Biden's withdrawal and the nomination of Kamala Harris as the Democratic Party's candidate have radically changed the landscape for the November election. Kamala Harris has reversed the favorable trend for Donald Trump that prevailed until July. The latest polls indicate that she is in a favorable position in key states such as Wisconsin, Pennsylvania, and Arizona. Her program would involve subsidies for housing purchases of up to \$25,000 for first-time buyers and other public transfers. The trade policy would likely remain in line with that of the Biden Administration, being aggressive towards China but without the global tariffs advocated by Donald Trump.

Short-lived market weakness

The violent market reaction to the rise in Japanese interest rates and the US economic releases at the beginning of August has given way to a rebound towards the year's highs in the stock markets. However, this rebound is made possible by lower bond yields. The US 2-year yield stands at 3.90 %, compared to around 4.40% during the peak of the stock market in July. The dollar-yen exchange rate reached its lows at 141.70 before fluctuating in a wide range between 142 and 149. The sensitivity of the Japanese stock market and, more generally, risky assets to the yen remains a key factor in market dynamics. Gold has regained its appeal as a safe-haven asset, especially as the premium on the dollar has diminished. Jerome Powell's Jackson Hole speech cements the prospects for monetary easing, benefiting interest rate-sensitive stocks and TIPS, which consider the dollar adjustment as a long-term inflation risk.

Apart from gold, other indicators demonstrate investors' risk aversion. The VIX index, derived from quotes of a basket of options on the S&P 500, briefly touched 65%, even though actual transactions in VIX futures contracts did not exceed 35%.

In the eurozone, the bond market is more responsive to US data releases than to European developments. The ECB has largely signaled a rate cut in September, bringing the Bund yield down to around 2.25%. Swap spreads have completely erased the widening initiated by French political risk. The Bund is trading at less than 30 basis points below the swap rate, nearly at its lowest level of the year. Sovereign spreads have quickly dampened the volatility affecting equities or the foreign exchange market. The OAT, which returned to 73 basis points, was, however, changing hands at a spread of 88 basis points at its highest on August 5th. Negotiations to form a government have resumed after the Olympic truce.

The credit market is seeing a return of primary issuance in the second half of August due to significant flows into specialized funds. ETFs no longer attract the entirety of the flows. The average spread on euro investment-grade bonds is 85 basis points versus swaps. High yield outperforms investment-grade in recent trades, despite valuations considered expensive by most investors. The resurgence of speculative-grade bond offerings spares the single-B segment, which continues to tighten against BB. The observed default rate over the past 12 months has deteriorated somewhat, but the asset class retains strong appeal. The iTraxx Crossover, used as a hedge, has fallen well below the 300 basis points threshold from a peak at 343 basis points on August 5th.

Conclusion

The summer of 2024 was marked by a violent correction following the rise in Japanese interest rates amid fears of a recession in the United States. The warning shot (-12% in one day on the Nikkei) did not lead to widespread distrust, and the risky asset markets subsequently rebounded.

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- **Market review**

The review will resume next week

● Main market indicators

G4 Government Bonds	02-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.41%	+1	+6	+1
EUR Bunds 10y	2.34%	+9	+16	+31
EUR Bunds 2s10s	-7.6bp	+8	+11	+31
USD Treasuries 2y	3.92%	-2	+4	-33
USD Treasuries 10y	3.9%	+9	+11	+2
USD Treasuries 2s10s	-1.7bp	+10	+8	+36
GBP Gilt 10y	4.05%	+14	+23	+52
JPY JGB 10y	0.91%	+2	+3	-41
€ Sovereign Spreads (10y)	02-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
France	71bp	+0	-1	+18
Italy	145bp	+10	+5	-23
Spain	82bp	+2	-2	-15
Inflation Break-evens (10y)	02-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2.03%	-3	-3	-10
USD 10y Inflation Swap	2.38%	-1	+9	-3
GBP 10y Inflation Swap	3.47%	-2	-4	-7
EUR Credit Indices	02-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	117bp	+1	+6	-21
EUR Agencies OAS	64bp	+0	-1	-6
EUR Securitized - Covered OAS	60bp	0	-3	-19
EUR Pan-European High Yield OAS	360bp	-11	-19	-39
EUR/USD CDS Indices 5y	02-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	53bp	+1	-10	-6
iTraxx Crossover	290bp	+3	-39	-24
CDX IG	49bp	0	-9	-7
CDX High Yield	322bp	+0	-45	-34
Emerging Markets	02-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	388bp	-9	-11	+4
Currencies	02-Sep-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	\$1.107	-0.922	1.439	0.3
GBP/USD	\$1.314	-0.424	2.672	3.2
USD/JPY	JPY 147	-1.715	-0.306	-4.0
Commodity Futures	02-Sep-24	-1wk (\$)	-1m (\$)	2024 (%)
Crude Brent	\$76.8	-\$3.5	\$0.6	2.1
Gold	\$2 501.4	-\$19.0	\$58.1	21.2
Equity Market Indices	02-Sep-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 648	0.24	5.65	18.4
EuroStoxx 50	4 948	1.39	7.03	9.8
CAC 40	7 632	0.54	5.24	1.2
Nikkei 225	38 701	1.55	7.77	15.6
Shanghai Composite	2 811	-1.56	-3.25	-5.5
VIX - Implied Volatility Index	15.69	-2.85	-32.92	26.0

Source: Bloomberg, Ostrum AM

Additional notes

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