Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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International tensions rise

Key Points

- **Divergence between equity and bond volatility**
- **Tactical long bias in US Treasuries, neutral on Bunds**
- **Widening in peripheral spreads in the wake of Spain bond auctions**
- **Stability in IG and high yield spreads**
- **Emerging debt spreads under 300bp mark despite international backdrop**

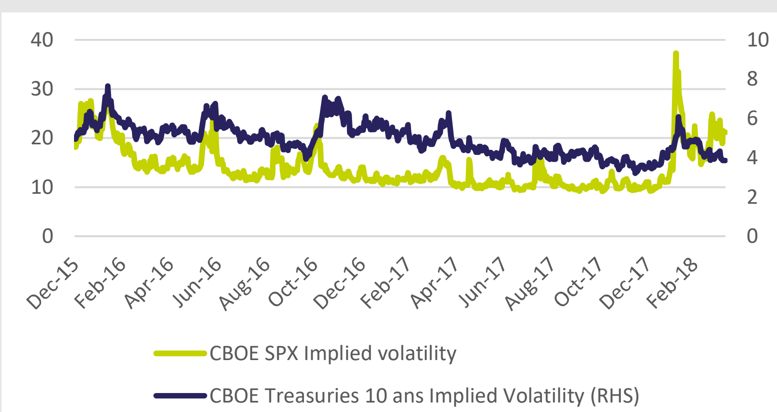
The S&P 500 equity benchmark lost 1.4% last week. European equities outperform thanks to the euro's fall below $1.23. announcements of protectionist measures generated volatile in equity space. Spill-overs onto bond markets have been limited. Gold dipped $11 last week. Treasury note yields increased to 2.80%, a 6bp rise last week. The US yield curve steepened slightly (+3bp on 2s10s spread). Gilt yields (1.41%) rose in the wake of US markets.

In the euro area, Bund yields are trading sideways about 0.50%. Auctions of long-term Spain Bonos and France OATs took a toll on peripheral bond spreads. Ten-yean Bonos spreads hover about 74bp vs. German Bunds.

Credit spreads are globally unchanged over the past week despite high volatility in equity markets. The iTraxx IG CDS index tightened by a modest 2bp to 57bp whilst cash corporate debt was stable. In turn, European high yield spreads stand at 326bp vs. Bunds.

In emerging markets, average spread on external debt dipped below 300bp.

Chart of the week



Since market turmoil in January, equity implied volatility has remained elevated above 20%.

Conversely, bond volatility has rapidly fallen back levels near 2017 historical lows.

This market backdrop could lead asset allocators to sell equities and add to bond holdings.

Tactical long stance in US bonds

The US bond market failed to respond to equity market weakness late last week. Protectionist measures announced will likely weigh on growth and may add to inflation risks. Current inflation dynamics already justify dialing down monetary support. The Fed has no reason to alter its rate path if the Trump Administration's trade policy contributes to raise inflation. In manufacturing, delivery times are increasing and input prices have been trending upwards. The Fed will likely pay attention to building supply constraints. At full employment (unemployment is currently 4.1%), expansionary economic policy primarily benefits the rest of the world. Excess domestic demand tends to accentuate external imbalances, which requires tighter monetary conditions. On our estimates, fair value in 10-year note yields is slight above 3%. Bearish consensus appears widespread across US bond markets. Short speculative positioning is quite important. Paradoxically, current sizeable short positioning likely prevents another upward run in US yields. Furthermore, asset managers including those using risk-parity investment processes must be encouraged to rebalance equity holdings into bonds due to volatility differentials. Final investor flows hence remain supportive of US Treasuries. In sum, a tactical long stance is warranted in US Treasuries. Curve flattening bias is also justified by prospects for further Fed rate increases.

Neutral Bund stance

In the euro area, 10-year Bunds are trading about 0.50%. Bund fair value is likely somewhat higher (0.65%) but expected reinvestment flows over the April-May period keep a lid on bond yields on a short-term horizon. The reduction in net public-sector bond purchases (down €1.1b to €20.7b in March) is insignificant relative to ECB reinvestment flows (€22.6b in April vs. less than €4b in March). Most activity surveys now suggest that the euro area economic cycle has peaked. This only adds support to euro government bond markets. The spread between German Bunds and US Treasury notes rose back to 230bp on 10-year maturities. In terms of duration positioning, we hold a neutral stance on euro bonds. Likewise, upside and downside risks appear balanced as concerns curve spreads. We hence recommend neutrality in 20s10 and 10s30s spreads. That being said, carry on curve flattening strategies is attractive under current market conditions. Prospects for higher rates in 2019 and ECB reinvestment of bond proceeds should contribute to a flatter term structure.

Bond auctions in Spain and France last Thursday sparked moderate spread widening. Brutal narrowing in Spain's Bonos spreads ahead of the bond sales (to as low as 66bp on 10-year maturities) was a reason for profit-taking, all the more so that the Spanish Treasury borrowed more than expected at the 30-year maturity.

Italy's BTP outperformance is likely a by-product of political stalemate since it prevents the formation of a government that would be critical of the euro and unlikely to maintain fiscal discipline. In addition, BTPs offer market depth unmatched by other peripheral bonds and a higher spread of 127bp on 10-year maturities. Furthermore, the widening in Portuguese bond spreads to about 120bp may entail a buying opportunity before Moody's rating decision on April 20th. Should the sovereign rating be raised, Portugal would be rated investment grade by all three major rating agencies.

Current spread valuations in core sovereign markets are too tight to anticipate further narrowing. Bunds indeed offer a better return-liquidity balance than comparable Dutch and Finnish government debt securities. Austrian bond deals will provide another test of market appetite for long-term debt. A neutral stance on OAT (24bp on 10-year maturities) reflects very favorable redemption flows in April.

Trendless credit spreads

The ECB was very active last week due to Easter break. The average spread on IG corporate bonds stands at 95bp vs. Bunds. Financials have tended to outperform slightly with spreads narrowing by a modest 2bp. There is little disparity in sectoral credit performances: the sharp rebound in energy equity prices (+3.9% in 5 days) or in the telecom sector did not show in credit space. Net bond purchases from CSPP still totaled €6.4b in March. The shift in the asset purchase program towards a greater share of corporate debt securities continues. It could be a deliberate ECB policy aimed at containing credit volatility at a time when volatility in equity space has notably increased. Indeed, volatility in credit markets is quite contained at present. For example, iTraxx IG spreads are slightly under the 60bp threshold, some 15 basis points above 2017 tightest levels. High-rated agency bonds and covered bonds are unchanged with spreads about 40bp. High yield has stabilized at 326bp but primary market activity is set to come back in the coming days.

Lastly, emerging bond spreads stopped tightening late last week. International tensions linked to US protectionism or other reasons (including sanctions towards Russia) have contributed to moderate yield premium widening as equity markets took a dive last Friday. Specific situations have also added to volatility as is the case for Brazil given the political backdrop there. The average on the external debt in US dollars is under 300bp.

Main Market Indicators

G4 Government Bonds	09-Apr-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.58 %	+2	-3	+5
EUR Bunds 10y	0.50%	+1	-14	+8
EUR Bunds 2s10s	109 bp	-1	-12	+3
USD Treasuries 2y	2.29 %	+4	+3	+41
USD Treasuries 10y	2.8 %	+7	-9	+40
USD Treasuries 2s10s	51 bp	+3	-13	-1
GBP Gilt 10y	1.41 %	+6	-9	+22
JPY JGB 10y	0.04 %	-1	-1	-1
€ Sovereign Spreads (10y)	**09-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	23 bp	+1	-1	-12
Italy	127 bp	-2	-10	-32
Spain	73 bp	+7	-5	-41
Inflation Break-evens (10y)	**09-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	142 bp	+0	0	-2
USD TIPS	209 bp	+3	-4	+11
GBP Gilt Index-Linked	307 bp	0	-1	+1
EUR Credit Indices	**09-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	95 bp	+0	+13	+9
EUR Agencies OAS	40 bp	+0	+2	+2
EUR Securitized - Covered OAS	40 bp	0	+3	+0
EUR Pan-European High Yield OAS	326 bp	+0	+25	+32
EUR/USD CDS Indices 5y	**09-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	58 bp	-2	+7	+13
iTraxx Crossover	283 bp	-1	+29	+51
CDX IG	65 bp	-3	+10	+16
CDX High Yield	359 bp	-10	+32	+52
Emerging Markets	**09-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	296 bp	-7	+10	+11
Currencies	**09-Apr-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.232	+0.19	+0.08	+2.6
GBP/USD	$1.413	+0.71	+2.05	+4.6
USD/JPY	¥107.07	-0.98	-0.23	+5.25
Commodity Futures	**09-Apr-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$68.4	$0.8	$3.2	$2.6
Gold	$1 333.5	-$5.9	$9.5	$30.7
Equity Market Indices	**09-Apr-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 641	2.53	-5.00	-0.99
EuroStoxx 50	3 415	1.59	-0.17	-2.54
CAC 40	5 263	1.86	-0.21	-0.93
Nikkei 225	21 678	1.35	0.97	-4.77
Shanghai Composite	3 138	-0.70	-3.64	-5.11
VIX - Implied Volatility Index	20.56	-13.84	39.00	84.33

Source: Bloomberg, Ostrum Asset Management

Writing

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