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Protectionism rocks markets

Key Points

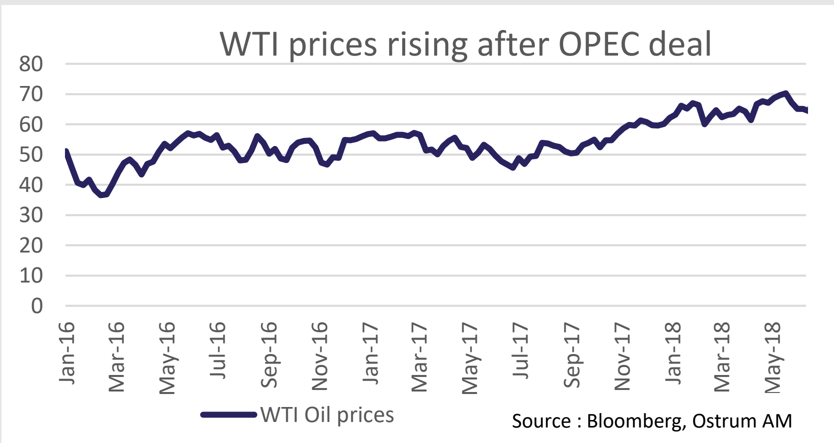
- **Politics weigh on equities, Bund yields close to 0.30%**
- **US protectionism extends to technology sector**
- **Italian debt spreads are wider before a tough July**
- **CDS market indices on shy grounds**
- **Stabilization in emerging debt space**

The German Bund was in high demand last week as US protectionist measures and political tensions in Europe shook markets. Bund yields hover about 0.32% (-7bp) and European stocks were down 2% last week. Volatility on Italy's BTPs rose as spreads are now close to 250bp sparking some contagion in peripheral bond markets. CDS indices have had a rocky week. The crossover index trades above 310bp. Volatility is lower in cash bond markets but spreads have widened somewhat (115bp). High yield spreads increased 19bp against Bunds last week, which represents a 78bp widening in 2018.

T-notes have mirrored the Bund rally despite a slight underperformance. T-note-Bund spread is now about 255bp. In the emerging world, emerging debt has stabilised about 355bp over US Treasuries. Chinese stocks have been hit by US trade measures. The Shanghai index is down 13.5% in 2018.

The US dollar hit a pause. The euro is up modestly near $1.17. In the UK, the majority in favour of a status quo on rates is now slightly slimmer. Sterling rallied to 1.33$.

Chart of the week



OPEC reached an agreement to raise output by up to 1mn barrels per day.

Saudi Arabia had been pressured by the US and China to bring prices down. Iran did not veto the decision which did support oil prices.

This will compensate output losses from Venezuela and sanctioned Iran. US oil production should also be boosted.

Conflicts do support safe havens

Political risk in Italy is starting to morph into a European problem. The Chaotic management of the migrant crisis exposes governance weaknesses within EU. In parallel, on the other side of the Atlantic, protectionist measures taken by Donald Trump has ignited retaliation from China and Europe. The IMF has warned against negative effects of protectionism as a slowdown in the world economy looks underway. The OPEC+ decision to raise output contributed to stabilize oil prices. Brent is trading close to $74 per barrel. That said, 2016 quotas could be restored at a future date.

The cyclical backdrop is deteriorating. Public and private investment appears to be softening in China. Consumption measured by retail sales is up less than 10% from a year earlier. European surveys have all peaked between December 2017 and February 2018. IFO suggests that Germany's growth may be decelerating even before US trade sanctions (on automotive imports) hit German manufacturers. Anxiety can be inferred from 2% loss in European equities.

Monetary authorities in China have lowered reserve requirements in a bid to boost credit. Capital outflows have indeed resumed which could result in a tightening in local financial conditions.

Italy still in the spotlight

ECB has once again opted for the softest monetary stance possible, but it may not be enough to prevent economic slowdown. This will be extremely challenging for Italy. The European Commission estimates that deterioration in global factor productivity is such that potential growth is no more than 0.5% per annum in 2018-2019.

Thus, Italy's sovereign bonds will remain vulnerable. Spreads on 10-year bonds are close to 250bp and market access conditions have deteriorated on long-term maturities. High coupon securities trade at a discount as perceived credit risk increases. Whilst euro exit is unlikely given the economic costs associated with leaving the currency bloc, the issue of debt restructuring will be raised by the time Italy enters recession again. July will be a tough month for the Italian Treasury. Scheduled bond auctions are supposedly covered by redemption flows in August. However, given rating risks (Fitch late August, Moody's early September), investors may refrain from reinvesting immediately in BTPs. For these reasons, we still prefer Spain and Portugal to Italy. Italian risk supports demand for Bund (0.32%) and a trend for a flatter yield curve. We retain a flattening view on 2s10s (about 100bp at present).

In the US, Fed policy keeps the curve flat. The international backdrop favours T-notes and justify overexposure to US rates, all the more so that short speculative positioning makes it more likely that buybacks would occur if tensions escalate. Short covering would spark some 10s30s steepening. Treasuries ETF Inflows have been matched with outflows from credit and high yield notably.

T-note is the safe asset of choice and within equities, US stock outperformance is testimony of the relative safety offered by US equity markets compared with, say, emerging markets. Despite an OPEC deal, WTI prices are up to $68. Beneficiaries of cartel agreements are very often outside the cartel. Energy stocks are hence well supported. That said, the US market has long been pulled by technology. In the next few days, the US Administration will announce export controls and restrictions on Chinese investment in advanced technologies developed in the US. This may have a negative impact on the US technology sector.

Pause in the dollar uptrend

The sharp rise in the dollar since April 16 is traceable to both firm Fed policy and realignment of exchange rates following US protectionist measures. Such trend may wane if markets refocus on US external imbalances. The ECB, the BoJ and the BoE all hesitate to exit ultra-accommodative policies. The BoE is one step closer to a rate rise in August. Andy Haldane whinged his vote to a 25bp hike at the last MPC meeting. Sterling rallied immediately to about $1.33. In emerging markets, Brazil monetary authorities had intervene to stabilize the real.

Emerging markets remain subject to selling pressure especially in local-currency space. Conversely, USD-denominated bonds in the EMBI Global Diversified index have tightened to about 350bp. Premiums on 10-year sovereign Mexican bonds (160bp) and Brazil (300bp) have started to ease modestly. Turkey does not benefit from the trend for tighter spreads after the controversial outcome of Presidential elections.

Main Market Indicators

G4 Government Bonds	25-Jun-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.67 %	-6	-5	-5
EUR Bunds 10y	0.33%	-7	-8	-10
EUR Bunds 2s10s	100 bp	-1	-3	-5
USD Treasuries 2y	2.53 %	-2	+6	+65
USD Treasuries 10y	2.88 %	-3	-5	+48
USD Treasuries 2s10s	35 bp	-2	-11	-17
GBP Gilt 10y	1.29 %	-3	-3	+10
JPY JGB 10y	0.04 %	-1	-1	-1
€ Sovereign Spreads (10y)	**25-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	39 bp	+7	+9	+3
Italy	250 bp	+34	+44	+91
Spain	102 bp	+17	-4	-12
Inflation Break-evens (10y)	**25-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	147 bp	0	+2	+4
USD TIPS	212 bp	-2	+1	+14
GBP Gilt Index-Linked	305 bp	-1	+1	-1
EUR Credit Indices	**25-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	115 bp	+4	+15	+29
EUR Agencies OAS	50 bp	+3	+7	+12
EUR Securitized - Covered OAS	54 bp	+3	+10	+14
EUR Pan-European High Yield OAS	372 bp	+19	+40	+78
EUR/USD CDS Indices 5y	**25-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	73 bp	+5	+8	+28
iTraxx Crossover	312 bp	+15	+17	+80
CDX IG	65 bp	+4	+2	+16
CDX High Yield	341 bp	+8	-2	+34
Emerging Markets	**25-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	355 bp	-1	+28	+70
Currencies	**25-Jun-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.170	+1.15	+0.64	-2.52
GBP/USD	$1.328	+0.83	-0.23	-1.71
USD/JPY	¥109.5	+0.41	-0.07	+2.91
Commodity Futures	**25-Jun-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$74.6	-$0.7	-$1.8	$9.5
Gold	$1 266.7	-$9.1	-$31.5	-$36.1
Equity Market Indices	**25-Jun-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 714	-2.16	-0.27	1.51
EuroStoxx 50	3 369	-2.81	-4.16	-3.85
CAC 40	5 284	-3.06	-4.67	-0.54
Nikkei 225	22 338	-1.51	-0.50	-1.87
Shanghai Composite	2 859	-5.38	-8.98	-13.54
VIX - Implied Volatility Index	17.72	43.95	34.04	60.51

Source: Bloomberg, Ostrum Asset Management

Writing

AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

Legal information

www.ostrum.com

Ostrum Asset Management
Registered Office: 43, avenue Pierre Mendès-France – 75013 Paris – Tel. +33 1 78 40 80 00
Limited Liability Company, Share Capital €50,434,604.76
Regulated by AMF under n°GP 90-009
Company Trade Registration (RCS) Number 329 450 738 Paris

Ostrum Asset Management

An affiliate of: NATIXIS INVESTMENT MANAGERS