Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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Temporary respite in markets

Key Points

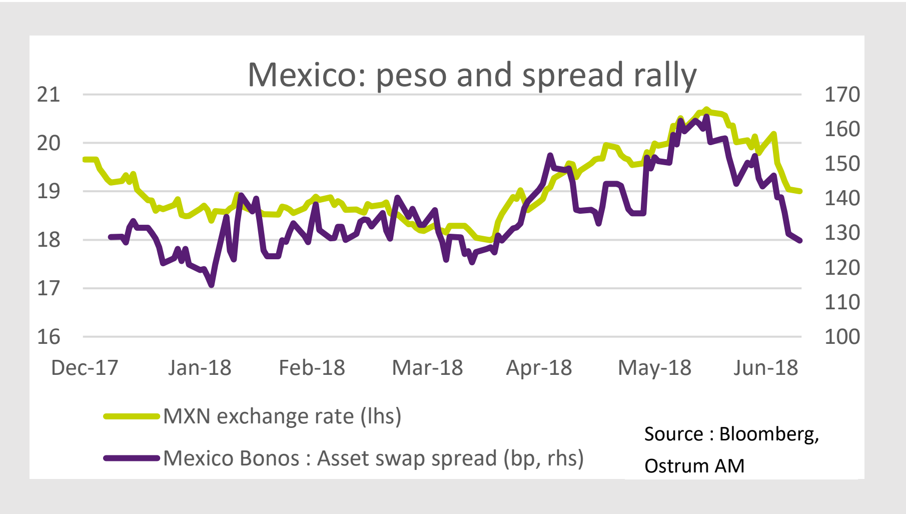
- **Economic releases overshadow trade war**
- **Low rates benefit risky assets**
- **Equities bounce along with high yield, subordinated debt**
- **Emerging debt takes a breather amid weaker dollar**
- **Strong rebound in peso, tighter spreads**

The 4th of July break coincided with portfolio reshuffling favouring risk assets, though without impacting safe bond yields. Pessimistic consensus fanned by the trade war has dissipated as economic indicators painted a brighter picture.

Developed stock markets recorded solid rises last week. In the meantime, the fall in emerging equity markets moderated. Shanghai bounced by 2.5% on Monday after having lost more than 20% from 2018 highs. Spreads in high yield markets have diminished. Euro credit outperformed by 1pb. Conversely, risk-free rates barely moved. T-note yields hover about 2.85% whilst Bunds remain stuck about 0.30.%. Italian spreads still trade near 240bp. Inflation linkers seem to price in no deterioration in the inflation backdrop. Lastly, the resignation of Brexit Minister David Davis has had little impact on either sterling or Gilts.

Weaker dollar ($1.17) does benefit all markets in the emerging world. The spectacular rebound in the Mexican peso is concomitant with widespread external debt spread narrowing. The real is nevertheless fragile and still close to BCB intervention levels.

Chart of the week



President-elect Obrador ('AMLO') managed to reassure the business community as regards both the fiscal outlook and ongoing trade negotiations in North America.

The peso jumped by 5.7% against the dollar since the July 1 elections.

The spread on 10-year Bonos at 126bp against swaps has now retraced the bulk of pre-election widening.

Economic release buoy asset prices

The rebound in equity prices and more generally in risky assets appears rooted in upbeat economic releases last week. US growth may have been about 4%qa in the second quarter. Trade and household demand contribute to a reacceleration in activity after a soft patch in 1Q (2%qa). The monthly deficit in goods trade has narrowed to $65b from as much as $78b last winter. On the employment front, the private sector added 202k new jobs in June. The unemployment rate went up 4% on higher labour market participation (which is a positive). Manufacturing and service-sector surveys both indicate strong activity ahead. New orders and new business paint a rosy picture, even in export markets. The dollar rise has had little impact on activity so far. That said, delivery times are increasing in many sectors. Input costs amplified by protectionist measures are a source of concern. In the euro area, prices are up 2%y in June. Surveys which had been down in the first half of 2018 now show signs of stabilisation. Growth is no longer as high as in the second half of 2017 but some encouraging signs are visible in German factory orders for instance.

The firmer growth backdrop has not triggered bond selling. Far from it. Bund yields are trading just above 0.30%, slightly below our modelled fair value of 0.38%. Duration positioning among most final investors remain close to neutrality. Curve flattening (with 30-year yields at 1%) is encouraged by rumours that the ECB may reinvest bond proceeds on long-term maturities. Although Benoît Coeuré remained quite ambiguous on the subject, the ECB has full flexibility to implement its reinvestment policy and ward off possible yield tensions stemming from Italy or Fed tightening. In sum, yield curve flattening is consistent with a reduction in risk aversion. It is worth maintaining a neutral duration stance in the euro area.

The US backdrop is similar. The absence of bond market reaction to risk taking. Short positioning has come down about July 4th. Demand for duration remains quite strong among institutional investors. The yield on 30-year bonds has logically broken below the 3% mark and 10s30s spread has narrowed to close to 10pb. We see little catalyst for a rapid increase in yields towards 3% on 10-year notes and a possible test of earlier highs at 3.12%. Duration neutrality is warranted for the time being. The Fed gave itself plenty of time to act by introducing symmetry in its inflation target. The rate path is quite straightforward which helps maintaining term premiums on long-term bonds at low levels. Index-linked securities remain inert to inflation rises which may reflect expectations of a price slowdown in the second half of 2018.

Risk appetite returns

Equity markets have erased part of the losses over the past month. S&P 500 went up 1.5% last week thanks to technology, health care and utilities. Institutional accounts are taking on risk again after having offloaded half of their equity exposure between end-January and mid-June. Implied volatility dipped back to 13%, which highlights low risk aversion. In Europe, indices gained about 2% last week. Automotive stocks (+3%) reacted positively to US ambassador in Germany promised no tariff on German car exports. Telecoms and utilities have outperformed among defensives, in part because of their sensitivity to interest rates.

In credit markets, spreads are down 1bp in the past five sessions. The average premium is 121bp against Bunds but investors hesitate to come back on euro corporate bonds. Corporate credit ETFs are undergoing outflows. Outperformance of bank and insurance subordinated debt is indicative a beta rally, the opposite of previous weekly declines. On a sector basis, energy and autos beat broad indices. High yield benefits from widespread risk taking. Net final investor flows, whilst still a global net outflow, have moderated somewhat. Average spreads in the asset class rallied through the 400bp mark vs. Bunds.

Narrower spreads in emerging debt

Emerging debt spreads have narrowed (-16bp to 353bp) helped by a weaker dollar. Colombia has tightened by as much as 30bp since the elections. Russia is benefitting from dearer oil prices ($78 per barrel on Brent). In Mexico, President-elect Obrador sought to reassure the financial community immediately after the election about the fiscal outlook and ongoing trade negotiations with the US in particular.

The Mexican peso jumped towards 19 pesos per dollar and spreads have come in considerably. Asset allocators appear to consider buying back sovereign emerging bonds denominated in US dollars. The investment flow situation remains however less supportive on local-currency debt.

Main Market Indicators

G4 Government Bonds	09-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.65 %	+3	+0	-2
EUR Bunds 10y	0.30%	0	-15	-13
EUR Bunds 2s10s	95 bp	-4	-15	-11
USD Treasuries 2y	2.56 %	+1	+6	+67
USD Treasuries 10y	2.85 %	-2	-10	+44
USD Treasuries 2s10s	29 bp	-3	-16	-23
GBP Gilt 10y	1.25 %	0	-14	+6
JPY JGB 10y	0.04 %	+2	-1	-1
€ Sovereign Spreads (10y)	**09-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	34 bp	-1	-3	-2
Italy	237 bp	+2	-32	+78
Spain	99 bp	0	-3	-15
Inflation Break-evens (10y)	**09-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	149 bp	+2	+3	+6
USD TIPS	214 bp	0	+1	+15
GBP Gilt Index-Linked	303 bp	-3	-5	-3
EUR Credit Indices	**09-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	121 bp	-1	+8	+35
EUR Agencies OAS	51 bp	+1	+1	+13
EUR Securitized - Covered OAS	55 bp	+1	+2	+15
EUR Pan-European High Yield OAS	388 bp	-12	+31	+94
EUR/USD CDS Indices 5y	**09-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	68 bp	-7	-4	+23
iTraxx Crossover	303 bp	-23	+3	+71
CDX IG	64 bp	-3	0	+15
CDX High Yield	345 bp	-18	+2	+37
Emerging Markets	**09-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	353 bp	-16	+16	+68
Currencies	**09-Jul-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.175	+1.27	-0.35	-2.15
GBP/USD	$1.322	+0.75	-1.17	-2.15
USD/JPY	¥110.76	+0.07	-0.68	+1.74
Commodity Futures	**09-Jul-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$77.9	$0.6	$1.7	$13.1
Gold	$1 260.4	$18.4	-$39.9	-$42.4
Equity Market Indices	**09-Jul-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 782	2.32	0.09	4.04
EuroStoxx 50	3 460	2.62	0.38	-1.24
CAC 40	5 398	2.30	-0.96	1.61
Nikkei 225	22 052	1.10	-2.83	-3.13
Shanghai Composite	2 815	1.43	-8.22	-14.88
VIX - Implied Volatility Index	12.73	-20.88	4.52	15.31

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