STRATEGY WEEKLY

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Markets hoping for a trade war truce?

Key Points

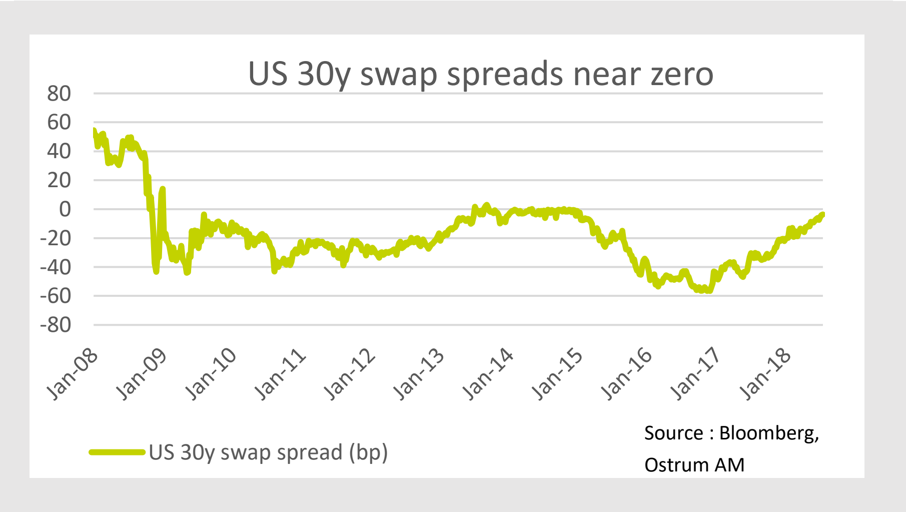
- **US inflation highest since 2012 (2.9%y)**
- **Risk asset rally continues (equities, credit, emerging)**
- **S&P buoyed by strong 2q18 earnings releases**
- **Bund and Treasuries go sideways**
- **Italy's spreads easing after reassuring bond auctions**

Despite the ongoing trade war climate, financial markets remain upbeat. Equity prices are up (+1.5% on the S&P 500 benchmark), spreads tighten globally, whilst risk-free rates in both the US and Germany barely move. Equity volatility has fallen again. Curve flattening is evidence of strong demand for rate duration despite allocation flows into risky assets.

Successful bond auctions in Italy trigger some easing in short-dated spreads. Credit spreads in the euro area (116bp against Bunds) have come in despite investor caution about the asset class. Financials keep trailing the overall credit market. ITraxx crossover has tightened by 31bp month-to-date. High yields spreads have eased in parallel. Breakeven inflation rates have decreased slightly on the back of lower oil prices.

In foreign exchange markets, the Japanese yen weakened to 112 against the dollar allowing for a sharp bounce in the Nikkei. The euro hovers about $1.17 while the Mexican peso continued to rise. Peso bounce also helped to reduce external debt spreads.

Chart of the week



There is considerable demand for US duration from defined benefit pension funds.

Rising (scheme guarantee) premiums force pension funds to reduce their duration gap and cut their deficits at a time when equities are near all-time highs and yields have risen from 2016 lows.

Curve flattening and shrinking swap spreads result from asset allocation shifts from US pension funds.

Macro worries vs. micro trends

The protectionist wave relentlessly fanned by Donald Trump represents the largest risk over the global economic cycle. That's said, new US tariff threat impacting $200b worth of Chinese products has yet to spell retaliation from China, which now appears less willing to add fuel to the fire.

The truce did benefit risk assets. Equity markets in the US hence refocused on fundamentals as the earnings season starts. Out of 28 releases, just two failed to beat consensus estimates. Sales growth was 8.3%y in the second quarter and net corporate income is increasing to the tune of 20% from a year ago. Dollar strength and restrictive trade policy have had little impact to date on corporate activity and performance. Technology and industry have recorded the highest earnings growth.

Investor positioning does not look excessive, and enabled a rebound in the S&P index above the 2800 mark. CFTC data on future and option holdings reveal that speculative accounts remain net sellers of US equities. Furthermore, fiscal easing triggered many announcements of share buyback programs in the US. Corporates are net buyers of equities to the tune of hundreds of billion dollars a year, either for acquisition purposes or returning cash to shareholders. The latest buyback announcements pertain to the financial sector. Earnings per share tend to rise as the capital base is depleted through share buybacks. Indeed, at the macroeconomic level, leverage has been on a constant rising trend since 2012 in the non-financial sector. Despite some easing of late, investment grade spreads are still 25bp wider than at the start of the year.

Consumer credit rose $24.5b in May, a very high monthly increase historically. Household credit remains dynamic even as defaults on credit cards and auto loans increase. Monetary policy is accommodative ignoring accelerating inflation on a dubious argument of "symmetry around the 2% target". CPI inflation is at its highest level (2.9%y) since 2012. Fed policy predictability is a key reason for continued curve flattening. The 2s10s spread is trading about a mere 25bp and 10s30s hovers near 10bp. Besides monetary policy, it appears that bond stripping activity on long-term Treasuries is driven by strong duration demand from US pension funds. In this context, regained appetite for risk assets (equities, credit) should not trigger a sharp yield increase. The gap to fair value (which we see at 3.02% on 10-year notes) is unlikely to be close in the very near term. Duration neutrality is hence warranted around a flattening on view expressed on 2s10s spreads.

In the euro area, surveys have ceased to deteriorate in May-June. Inflation ticked higher in most countries. The hiccup in the economic slowdown may not be indicative of an imminent rise in bond yields, as the ECB retains plenty of flexibility with its reinvestment policy. Bund Feb28 broke below its 0.30% floor last week, which entails a bullish technical signal. Yield curve flattening in the German bond market is worth considering as it represents a positive carry opportunity.

About spreads, easing continues with a pickup in risk appetite. Bond auctions in Italy attracted sound demand including on 20-year BTP yielding 3.26%. The spread on 10-year BTPs is now close to 220bp. It is of the utmost importance that Italy retains adequate market access ahead of rating decisions by Fitch and Moody's in a few weeks' time. Spain tightened towards 90bp against Bunds after Ficth maintained it's a rating. It is hence recommended to hold on to Spain overexposures (91bp on 10-year bonds) and Portugal (139bp). The government crisis in the UK has had surprisingly little impact on Gilts considering what is at stakes. British bonds trade under 1.30%.

Euro area credit markets benefit from rising risk appetite. The trend in iTraxx crossover (291bp) reversed sparking a sharp 30bp spread tightening month to date. Technical signals have turned indicating tightening from July 4th. Whilst corporate bonds are less responsive than indices, spreads(116bp) have also come in (-5bp last year). Flows suggest that asset allocators remain unwilling to add to euro IG credit holdings. Financials keep underperforming the broader market although high beta subordinated debt securities fared well. High yield spreads trade at 365bp compared with more than 400bp earlier this month.

Emerging debt tightening

The improvement in high yields resonates in emerging markets. The broad dollar uptrend against emerging market currencies is moderating, despite lingering downside risks in both Argentina and Turkey. The benchmark spread gauge is now 341bp over US treasuries (-12bp last week). Peso appreciation reduces the risk on BBB+ Mexican credit so that spreads on USD-denominated bonds is now 138bp. However, on IIF data, investors appear to have pulled $14b worth of both bond and equity holdings from emerging markets In May and June. Fund inlows have seemingly stabilized last week after a difficult three-month period.

Main Market Indicators

G4 Government Bonds	16-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.63 %	+2	-1	0
EUR Bunds 10y	0.36%	+6	-4	-7
EUR Bunds 2s10s	99 bp	+4	-3	-7
USD Treasuries 2y	2.6 %	+4	+6	+72
USD Treasuries 10y	2.86 %	+0	-6	+45
USD Treasuries 2s10s	26 bp	-4	-12	-27
GBP Gilt 10y	1.29 %	+4	-4	+10
JPY JGB 10y	0.04 %	+0	+0	-1
€ Sovereign Spreads (10y)	16-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
France	28 bp	-6	-5	-7
Italy	222 bp	-14	+2	+63
Spain	92 bp	-7	+3	-22
Inflation Break-evens (10y)	16-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	146 bp	-3	-1	+3
USD TIPS	211 bp	-3	-2	+13
GBP Gilt Index-Linked	304 bp	+1	-2	-2
EUR Credit Indices	16-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	116 bp	-5	+3	+30
EUR Agencies OAS	50 bp	-1	+2	+12
EUR Securitized - Covered OAS	54 bp	0	+3	+15
EUR Pan-European High Yield OAS	365 bp	-23	+12	+71
EUR/USD CDS Indices 5y	16-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	64 bp	-4	-4	+19
iTraxx Crossover	291 bp	-12	-6	+59
CDX IG	62 bp	-1	+1	+13
CDX High Yield	335 bp	-3	+2	+28
Emerging Markets	16-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	341 bp	-12	-11	+56
Currencies	16-Jul-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.171	-0.33	+0.89	-2.47
GBP/USD	$1.326	+0.35	+0.15	-1.86
USD/JPY	¥112.38	-1.39	-1.71	+0.28
Commodity Futures	16-Jul-18	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$73.3	-$4.8	$0.2	$8.5
Gold	$1 240.8	-$18.3	-$37.8	-$62.0
Equity Market Indices	16-Jul-18	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 801	0.62	0.78	4.78
EuroStoxx 50	3 453	-0.21	-1.48	-1.45
CAC 40	5 417	0.34	-1.55	1.96
Nikkei 225	22 597	3.71	-1.11	-0.74
Shanghai Composite	2 814	-0.04	-6.88	-14.91
VIX - Implied Volatility Index	12.27	-3.31	2.42	11.14

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

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