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STRATEGY WEEKLY

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Trump erupts in rate debate

Key Points

- **Powell maintains gradual tightening path, faces Trump's critics**
- **Strong US growth in 2Q 2018**
- **Sell US treasuries, neutral stance on Bunds**
- **US earnings season off to strong start**
- **Investors back in high yield and emerging market debt**

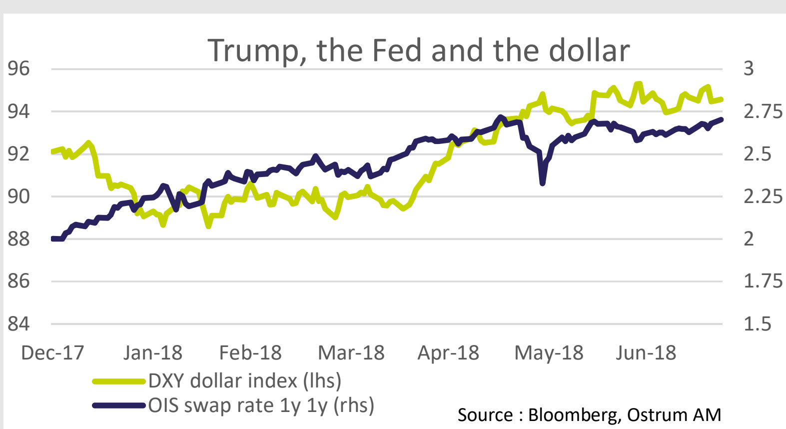
Donald Trump's comments on Fed monetary policy and the US dollar jolted financial markets that had been particularly calm since the start of July. Despite positive earnings releases, US stocks traded sideways last week. Earnings growth has been less supportive in Europe.

Us 10-year yields have crept higher towards 2.90%, hence erasing part of the earlier curve flattening. In the euro area, Bund yields trade close to 0.40% and peripheral sovereign spreads tighten slightly. In Japan, 10-year yields near 0.10%. have shown unusual volatility. Market participants allegedly expected the BoJ's yield curve control policy to be amended.

As concerns credit, subordinated financial debt keeps underperforming in trendless corporate bond markets. Meanwhile spreads eased in both high yield and emerging markets last week.

Mr Trump's comments have triggered some adjustment in the US dollar. The euro is slightly above $1.17 and the dollar-yen rate is down to 111. The Brazilian real appreciated by 1.6% last week against the greenback.

Chart of the week



Does Donald Trump tray to influence Fed policy? The US President openly criticized the Central bank's policy arguing that the US dollar was too strong and that higher rates were detrimental to growth.

It is unusual for a President to interfere with Central bank policy. The Fed is independent and will continue withdrawing excess liquidity. Furthermore, dollar strength may be rather traceable to protectionism championed by Donald Trump.

Strong growth in 2q18

The US economy accelerated in the second quarter. In the three months to June, US GDP likely expanded at an annualized rate of 4%. Household consumption of goods, stimulated by easy credit, has picked up and private investment is still upbeat. Employment is growing quickly enough to absorb new entrants and keep unemployment (4% in June) below its long-run norm. The trade balance is improving thanks to a surprisingly sharp increase in US goods exports. Foreign importers likely anticipated trade restrictions to be implemented in response to US protectionism. Deficit reduction may hence be short-lived but foreign demand will add about half a percent to US growth in the second quarter.

Powell reasserts gradualist approach

Given rising inflation, Jerome Powell has “for now” no reason to change the Fed rate path. Two more hikes of 25bp may be in the cards in September and December of this year. This is the main takeaway from Chair Powell’s testimony before Congress last week. The balance sheet policy beyond 2018 will have to be reviewed but Fed communication has not yet evolved on this matter. Trump’s ire did cause some volatility in the market but Fed officials are unlikely to be moved by critics. The US equity market is faring well thanks to incoming earnings releases. The earnings season is off to a strong start with 90% of publications beating consensus estimates. That said, valuation sin some sectors may make prices vulnerable to disappointments. Furthermore, another source of fragility pertains to leverage. Tax reform accelerated share buyback programs, especially in the financial sector which is now authorized by the regulator to return more cash to shareholders. This adds to strong merger and acquisitions activity. In fact, the US Corporate sector has been the main equity buyer for some time. Final investors conversely have been quite cautious regarding US equities.

In bond markets, higher inflation (2.9%y in June) represents a floor on 10y yields which could creep higher towards fair value, which we see at 3.02%. A short duration stance is recommended in US bond markets. The yield curve steepened slightly last week, with 30y yields rising above the 3% threshold. Under-reaction of breakeven inflation is a mystery in the context of higher inflation. Ten-year breakeven inflation is stable at 212bp. Sensitivity to oil prices, including short-term maturity bonds, is unusually weak.

Furthermore, the Japanese market appears to be expecting a change in BoJ policy. It is highly unlikely that the BoJ would reconsider its 10-year JGB yield targeting policy in the short run. Gilt outperformance (1.24%) despite expectations of a rate rise in August is hard to apprehend. A short stance is till appropriate.

ECB: the twist temptation

In the euro area, Bund yields have ranged between 0.30% and 0.50% since the political crisis unfolded in Italy. The German bond yield (0.40%) is trading in the middle of this range ahead of the ECB meeting on Thursday. This rendezvous may be uneventful but the ECB has yet to unveil potential changes to its bond reinvestment policy. A broadening of maturity constraints could be in the cards especially if the ECB wants to shelter European bonds from potential upside risk stemming from the US. Markets remain sensitive to developments in Italy. Monetary policy bias will thus stay accommodative, which will benefit peripheral bonds. Spain is trading near 100bps, Portugal is close to 140bp on 10-year tenors.

Equity markets have been hesitant as performance year-to-date is minus 1% for the main European benchmark. Outflows from equity funds continue. The beginning of the earnings season is lacklustre, with positive and negative surprises balancing out. However, earnings have come in on the soft side in the consumer sector. The modest rise in the euro may have weighed on equity performance relative to the US.

Flows return in high yield

Credit remains penalised by tensions on financials’ spreads. Indeed, the iTraxx Subordinated Financials index widened by 10bp last week to 167bp.

Conversely, the high yield bond market attracts bond investor interests again. After a challenging spring period, outflows have diminished and may be turning positive in July. This is all the more remarkable that euro investment grade fund flows remain negative (IG spreads hover about 117bp against Bunds). High yield is now trading around 370bp vs. Bunds.

Stronger demand for higher-risk credit may have benefitted emerging bond markets. Emerging debt denominated in US dollars is priced at 340bp spreads over Treasuries on average. Flows into emerging bond funds have been picking up in keeping with the stabilisation in foreign exchange rates. The bounce in the Brazilian real (+1.6% last week) allowed for a reduction in Brazil spreads towards 278bp after a peak at 338bp in mid-June.

Main Market Indicators

G4 Government Bonds	23-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.6 %	+2	+6	+3
EUR Bunds 10y	0.41%	+4	+7	-2
EUR Bunds 2s10s	101 bp	+2	+1	-5
USD Treasuries 2y	2.62 %	+2	+8	+74
USD Treasuries 10y	2.95 %	+9	+6	+55
USD Treasuries 2s10s	33 bp	+7	-2	-19
GBP Gilt 10y	1.27 %	-1	-5	+8
JPY JGB 10y	0.09 %	+5	+5	+4
€ Sovereign Spreads (10y)	23-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
France	31 bp	+2	-6	-5
Italy	223 bp	+2	-12	+64
Spain	97 bp	+6	-4	-17
Inflation Break-evens (10y)	23-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	142 bp	-3	-5	-1
USD TIPS	212 bp	+1	-2	+14
GBP Gilt Index-Linked	302 bp	-2	-2	-4
EUR Credit Indices	23-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	117 bp	+1	+5	+31
EUR Agencies OAS	49 bp	-1	+2	+11
EUR Securitized - Covered OAS	53 bp	-1	+2	+14
EUR Pan-European High Yield OAS	367 bp	+2	+8	+73
EUR/USD CDS Indices 5y	23-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	66 bp	+2	-7	+21
iTraxx Crossover	293 bp	+3	-20	+60
CDX IG	62 bp	+1	-5	+13
CDX High Yield	339 bp	+2	-11	+32
Emerging Markets	23-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	339 bp	-2	-24	+54
Currencies	23-Jul-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.170	-0.05	+0.07	-2.54
GBP/USD	$1.311	-0.94	-1.21	-3.02
USD/JPY	¥111.46	+0.78	-1.71	+1.1
Commodity Futures	23-Jul-18	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$72.7	$0.9	-$2.6	$8.0
Gold	$1 223.8	-$15.2	-$42.3	-$79.0
Equity Market Indices	23-Jul-18	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 807	0.32	1.91	5.01
EuroStoxx 50	3 454	0.14	0.36	-1.42
CAC 40	5 378	-0.58	-0.17	1.24
Nikkei 225	22 397	-0.89	-0.53	-1.62
Shanghai Composite	2 860	1.62	-1.05	-13.54
VIX - Implied Volatility Index	12.79	-0.31	-7.12	15.85

Source: Bloomberg, Ostrum Asset Management

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