Ostrum ASSET MANAGEMENT
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STRATEGY WEEKLY
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Risk appetite returns

Key Points

- **US growth hit 4.1%qa in 2Q18**
- **Strong US earnings season but market slams negative surprises**
- **Fed stance unchanged this week, BoE to hike rates**
- **Short stance on Treasuries, neutral on Bunds**
- **Flows return to credit, emerging markets**

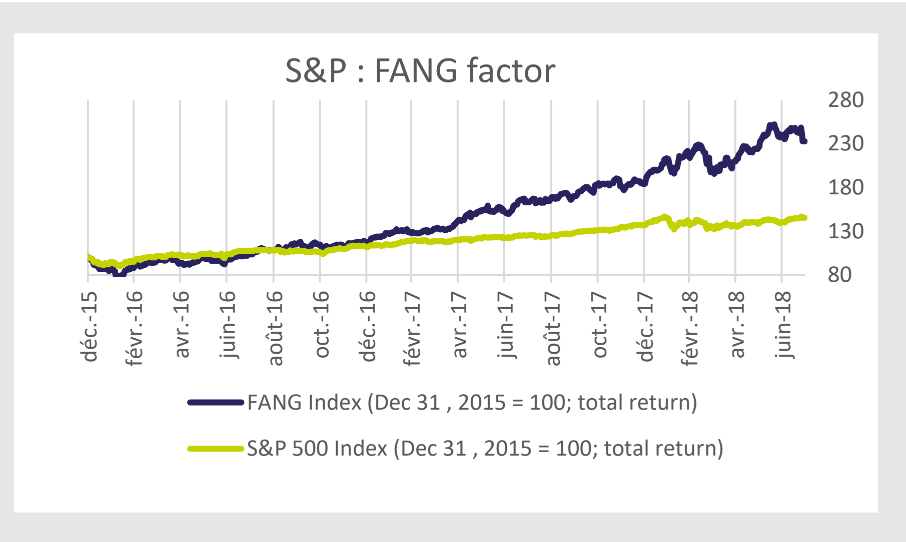
Solid growth in the US was received by stock markets. The S&P index climbed 0.6% last week. European stocks gained 2%. Earnings are supportive although disappointing releases have caused large corrections in technology. Valuation levels may be too high to accommodate downside EPS surprises.

The stock rise caused a modest increase in bond yields. The yield on 10-year is close to 3%. Bunds trade near 0.45%, which contribute to shrinking credit spreads. Subordinated debt fared well as risk appetite returned. Gold is down some $30 since the start of the month. Inflation breakeven are unchanged.

High yield spreads have come in significantly (-35bp) in July. Flows on emerging markets have picked up, as political noise and trade war risks receded somewhat. Emerging sovereign credit now trade near 325bp vs. Treasuries.

The dollar is stable against major crosses. The euro is below the $1.17 mark. Rises in Brazil's real and Mexico's peso are evidence of optimism towards emerging economies. That said, the fall in the Chinese yuan runs unabated.

Chart of the week



Highly traded technology stocks have made a considerable contribution to the overall market's performance in the past three years.

In 2018, the S&P index's rise is almost entirely traceable to high returns on such stocks.

Recent sharp drawdowns suggest current valuations cannot accommodate downside surprises on earnings.

High growth in the US

US GDP growth reached 4.1%qa in the second quarter. GDP expanded a revised 2.2%qa in the previous quarter. Household consumption picked up noticeably after a soft first quarter. Spending on consumer durables rose 9.3%qa in the three months to June. Investment remains solid in part due to tax relief. Structures investment is growing at double-digit rates. In turn, research and development investment is up 8.9%qa. Rising oil prices encourage crude output, which now tops 11mbpd. The rebound in exports is traceable in part to a sharp improvement in the energy balance. The US exported 2.3mbpd in the second quarter. The shrinking trade deficit hence added fully 1pp to growth in the past quarter. Conversely, public spending excluding military expenditure remains stagnant. Inventory change knocked 1pp off growth. The rebuilding of inventories may hence support production going forward. Tensions have appeared across the supply chain. The GDP deflator increased by 3%qa for the first time since 2007.

Equity markets have fully priced in the good news. Tax reform has sparked large cash repatriation by US corporations to the tune of about 145b in the first quarter. The cash flows have fuelled expansion in share repurchase programs through the seconds quarter. Mergers and acquisitions also supported stock prices. The quarterly earnings season so far entails strong support in most sectors. That being said, disappointing releases have led to sharp share price drops. Indeed, 23x valuation in technology stocks has resulted in asymmetrical market reactions.

Growth argues for continued rate increases and balance sheet normalisation. Jerome Powell will ignore political pressure in all likelihood. Status quo on Fed Funds rates is a given for this week. FOMC could nevertheless cut interest on excess reserves in a bid to facilitate balance sheet unwinding. The yield on 10-year note has crept higher to 2.98%. Potential upside to previous highs of 3.12% exists but Fed's gradual approach and persistent short positioning do reduce the probability of an outsized upward yield move. The inflation rise nevertheless provides a floor on 10-year yields. Trend for flatter curves (owing to Fed holdings and pension funds' duration needs) is costly in terms of carry, which indeed favours steepeners. We recommend no curve exposure at this juncture. The observed rise in inflation has had little effect on TIPS-implied breakeven inflation rates. Ten-year breakevens are stuck about 210bp despite a 2$ gain in oil prices last week (WTI topping $70).

Draghi gains time

In the euro area, Mario Draghi did not change policy and refused to answer questions regarding the reinvestment policy. Amounts to be reinvested over the next twelve months are immense. Redemption payments on public bond holdings total $146b until June 2019. Draghi's caution favours a narrowing in short-term swap spreads. In sovereign markets, as the risk of referendum on euro membership re-emerged last week, 10-year BTP spreads widened towards 230bp. Spain's Bonos were stable (97bp) despite a failure to vote the budget la. Twenty billions worth of redemption flows on July 31st helped tame market spreads. Portugal is outperforming.

Equity markets (up 2% last week) ignored lacklustre quarterly earnings publications. A weaker euro and less-stretched valuations compared with the US limit downside risk although economic slowdown already weigh on sales growth. Corporate bonds have been hit by sovereign bond volatility in the recent period. The balance of rating changes is nevertheless positive in Europe. After a tough spring end, flows are returning to the IG credit asset class in 3Q18. Final investors have bought back securities yielding 120bp more than Bunds at their highest. In speculative-grade space, spreads have shrunk some 35bp since the start of July. The 400bp level on spreads likely triggered demand for European high yield.

BoJ and BoE to change plans this week?

In Japan, markets have been speculating that exit from the yield targeting policy could be announced shortly due to its negative impact on bank margins. The yield on 10-year JGBs is trading about 0.10% despite BoJ commitment to keep yields about zero. It is unlikely in our opinion that Kuroda will put an end this policy at a time when inflation falls back. Meanwhile, BOE rates may be hiked to 0.75%. Markets are expecting a 25bp increase and a prolonged status quo for the next two years. The political backdrop has deteriorated of late but Mark Carney looks set to raise interest rates. Gilt yields may follow T-note yields to the upside.

Appetite for emerging markets returns

Latin-American currencies appreciated in the past few weeks. Mexican peso is trading within 19 against the US dollar. Market participants have been reassured by the new government's fiscal outlook. The latter helped spreads lower as 10-year Mexican Bonos now trade near 130bp. Brazilian real has also rebounded to 3.70 against the greenback. The balance of investment flows has considerably improved across emerging debt ETF markets. Spread on benchmark indices hover about 325bp over US treasuries compared with a peak at 374bps on June 19th.

Main Market Indicators

G4 Government Bonds	30-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.58 %	+2	+8	+5
EUR Bunds 10y	0.45%	+5	+15	+3
EUR Bunds 2s10s	103 bp	+3	+7	-2
USD Treasuries 2y	2.67 %	+4	+15	+79
USD Treasuries 10y	2.98 %	+2	+12	+57
USD Treasuries 2s10s	30 bp	-2	-3	-22
GBP Gilt 10y	1.35 %	+8	+8	+16
JPY JGB 10y	0.1 %	+2	+7	+5
€ Sovereign Spreads (10y)	**30-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	30 bp	-1	-6	-6
Italy	234 bp	+11	-4	+75
Spain	98 bp	+0	-4	-16
Inflation Break-evens (10y)	**30-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	143 bp	+1	-4	+0
USD TIPS	213 bp	+1	+0	+15
GBP Gilt Index-Linked	305 bp	+3	+0	-1
EUR Credit Indices	**30-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	112 bp	-5	-8	+26
EUR Agencies OAS	48 bp	-1	-3	+10
EUR Securitized - Covered OAS	52 bp	-1	-2	+12
EUR Pan-European High Yield OAS	355 bp	-12	-41	+61
EUR/USD CDS Indices 5y	**30-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	63 bp	-3	-13	+18
iTraxx Crossover	287 bp	-5	-39	+55
CDX IG	58 bp	-3	-10	+9
CDX High Yield	330 bp	-8	-33	+22
Emerging Markets	**30-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	324 bp	-15	-45	+39
Currencies	**30-Jul-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.171	+0.12	+0.98	-2.42
GBP/USD	$1.314	+0.28	+0.14	-2.74
USD/JPY	¥110.96	+0.42	-0.11	+1.56
Commodity Futures	**30-Jul-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$75.0	$2.0	-$4.2	$10.3
Gold	$1 224.3	$0.6	-$17.7	-$78.5
Equity Market Indices	**30-Jul-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 810	0.12	3.38	5.11
EuroStoxx 50	3 517	1.83	3.58	0.38
CAC 40	5 498	2.23	3.29	3.50
Nikkei 225	22 545	0.66	1.08	-0.97
Shanghai Composite	2 869	0.33	0.76	-13.25
VIX - Implied Volatility Index	13.52	7.13	-15.97	22.46

Source: Bloomberg, Ostrum Asset Management

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