Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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# September is never easy

## Key Points

- **European equity markets dropped last week**
- **Italian and trade talks in North America high on risk list**
- **Bund at 0.33%, wider sovereign and credit spreads**
- **Emerging markets underperforming**
- **Australia: the inevitable housing crisis**

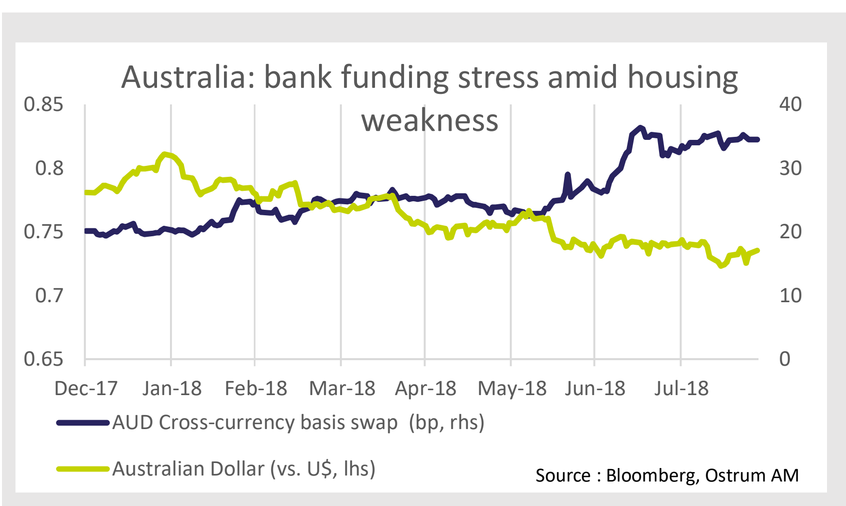
The last week of August was in line with the choppy beginning of the month. Risky assets have been weak to the benefit of safe government bonds. The situation across emerging markets remains precarious especially in South America. Argentina's central bank raised rates to 60% in a bid to stem selling pressure in FX markets.

In the euro area, the Italian government seeks to reassure markets. Fitch lower its Italian rating outlook on fiscal concerns. Spain and Portugal spreads widened also. Credit widened on increased issuance and investment fund outflows. Euro IG bond spreads went up 3bp last week. High yield resists despite volatile trading in CDS space. ITraxx crossover is trading about 300bp.

European equities closed the week on a weak note. EuroStoxx 50 lost nearly 2%. Retailing, banks and Telecommunications underperformed sharply. US stocks have been the safe haven especially against emerging markets including Shanghai.

The US dollar was up against North American currencies. Dollar strength is a by-product of Trump's protectionism. In turn, the Australian dollar is falling on housing woes limiting the prospects for higher RBA rates.

## Chart of the week




Low rates at full employment are a recipe for financial instability.

Australian monetary policy engineered a housing bubble, that appears to be popping. Housing prices have now fallen 11 months in a row.

Housing stress is reinforced by local banks' liabilities to the rest of the world. For these reasons, margins have widened in cross-currency swap markets and AUD is trading lower.

## United States: credit easing may prove dangerous

In the United States, the economy grew at an annualized rate of 4.2% in the second quarter. Data however hints at slightly slower growth in 3q18. Strong household consumption caused the trade deficit to widen again. Indeed, the goods balance showed a deficit of $72b in July. Housing investment is moderating. Annual price increases above 6% since 2012 has dented affordability all the more so that mortgage rates are trending higher. Inventories of homes for sale have been picked up noticeably lately. Conversely, business investment is still upbeat. Shipments of capital goods are rising at a 5%qa clip in the past three months. The San Francisco Fed's Tech Pulse index suggests that growth in the California technology sector remains in double-digit territory. All regional manufacturing gauges stand clearly in positive territory. ISM manufacturing may stay near cyclical highs. Inflation is slightly up. The consumption deflator was 2.3%y in July. The core inflation rate was 2%y. The Fed may hence keep on raising rates. Another aspect of policy may justify further tightening of financing conditions. The Fed's senior loan officer opinion survey (SLOOS) shows widespread easing of bank credit standards. Traditional banks are being undercut by fintech lenders, who have been gaining market shares across credit markets, including mortgage refinancing and (even unsecured) consumer loans. In turn, high CLO demand spurs the supply of commercial and industrial loans often without adequate credit protection. Such developments near the end of the economic cycle highlight the risk of adverse credit selection. If credit quality keeps worsening, a credit crunch will develop and send the economy into recession.

## Italian politics and trade talks make headlines

In financial markets, caution remains warranted. August turned out to be challenging for risky assets. The Italian political backdrop is on everyone's mind. Giovanni Tria aims at reassuring markets regarding the deficit outlook but constant pressure from Di Maio and Salvini cast shadow on fiscal commitments. Fitch (BBB, negative outlook) expressed its doubt by lowering its rating outlook. The update of the stability programme due on September 27 is awaited by markets. The European Commission will publish fiscal recommendations by November-end and S&P and Moody's will update their ratings in October. Italian spreads may thus continue to increase. In this context, it is hard to sell Bunds. Fair vale may be 0.52% on our estimates, but slower growth, inflation peaking this summer and the Italian government woes are reasons to hold a neutral stance. Furthermore, repo rates (as low as -3% on some German bonds) highlight scarcity problems. Long-term bond issuance in Spain and in France this week highlight the risk of long-end steepening.

## Euro credit underperforming

Corporate bonds have underperformed Bunds. The return of primary market issuance weighed on prices last week. The spread on IG bonds has widened back to summer highs. ITraxx IG is trading at 68bp. Fund flow data indicate that credit investors have been taking money off the table. The proportion of corporate bonds in the ECB's asset purchase programme diminished in July and August. Corporate bond amounts to be reinvested are negligible ($5b) compared with planned reinvestments of public-sector bonds ($146b) in the next 12 months to July 2019. One can be assured that the ECB will be flexible after QE ends in December. Despite volatility in iTraxx crossover spreads, high yield markets (+4bp at 359bp) have been resilient to weakness in IG spreads.

Equity markets react to incoming news on Italy and trade talks in North America. Discussions continue with Canada after the swift agreement signed with Mexico's outgoing President Nieto. Any trade agreement must go through US Congress… which may soon have a different majority. Donald Trump's threat to leave Canada out of a trade deal faces strong opposition from the business community. Against this backdrop, the dollar and US equity markets have been the safe havens. The S&P index (historical high) was up 0.9%µ last week whilst European indices were down 1-2%. It is true that earnings momentum is stronger in the US. Strong M&A activity and buybacks further increase the gap in EPS growth with Europe. The rise in leverage encouraged by Trump's massive tax cut is one of the main reasons behind the S&P's outperformance with high returns from the FAANG group (+30% YTD). In the euro area, economic indicators pointing down since the start of the year have coincided with outperformance of defensive sectors. Banks have also been under pressure. That said, asymmetry in the implied volatility curve may signal that above-mentioned risks are largely factored in by market participants.

Lastly, across emerging markets, Argentina's situation seems inextricable. Capital outflows and peso conversion into US dollars have forced short-term rates higher (to 60%). President Macri's call for early IMF disbursements failed to reassure investors, to say the least. The collapse of the Turkish lira entails a considerable constraint on import demand and broader economic growth. In this context, it is quite remarkable that the EMBI global diversified index only trade at 370bp spreads over US Treasuries.

## Main Market Indicators

| G4 Government Bonds | 03-Sep-18 | -1wk (bp) | -1m (bp) | Ytd (bp) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.6 % | -2 | -1 | +2 |
| EUR Bunds 10y | 0.33% | -4 | -8 | -9 |
| EUR Bunds 2s10s | 94 bp | -2 | -6 | -12 |
| USD Treasuries 2y | 2.63 % | -1 | -2 | +74 |
| USD Treasuries 10y | 2.86 % | +1 | -9 | +46 |
| USD Treasuries 2s10s | 23 bp | +3 | -7 | -29 |
| GBP Gilt 10y | 1.4 % | +13 | +8 | +21 |
| JPY JGB 10y | 0.12 % | +2 | +1 | +7 |
| **€ Sovereign Spreads (10y)** | **03-Sep-18** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| France | 36 bp | +2 | +3 | +0 |
| Italy | 283 bp | +5 | +31 | +124 |
| Spain | 112 bp | +8 | +10 | -2 |
| **Inflation Break-evens (10y)** | **03-Sep-18** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| EUR OATi | 138 bp | -1 | -3 | -5 |
| USD TIPS | 209 bp | -2 | -3 | +11 |
| GBP Gilt Index-Linked | 307 bp | +1 | +2 | +2 |
| **EUR Credit Indices** | **03-Sep-18** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| EUR Corporate Credit OAS | 119 bp | +3 | +9 | +33 |
| EUR Agencies OAS | 52 bp | +2 | +5 | +14 |
| EUR Securitized - Covered OAS | 53 bp | +0 | +2 | +13 |
| EUR Pan-European High Yield OAS | 359 bp | +4 | +2 | +65 |
| **EUR/USD CDS Indices 5y** | **03-Sep-18** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| iTraxx IG | 68 bp | +2 | +4 | +23 |
| iTraxx Crossover | 298 bp | +11 | +5 | +66 |
| CDX IG | 60 bp | +1 | +1 | +11 |
| CDX High Yield | 330 bp | +6 | +3 | +23 |
| **Emerging Markets** | **03-Sep-18** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| JPM EMBI Global Div. Spread | 370 bp | +8 | +43 | +85 |
| **Currencies** | **03-Sep-18** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| EUR/USD | $1.162 | -0.56 | +0.47 | -3.19 |
| GBP/USD | $1.288 | -0.1 | -0.92 | -4.68 |
| USD/JPY | ¥111.05 | 0 | +0.18 | +1.48 |
| **Commodity Futures** | **03-Sep-18** | **-1wk ($)** | **-1m ($)** | **Ytd ($)** |
| Crude Brent | $78.2 | $1.7 | $4.7 | $14.2 |
| Gold | $1 201.5 | -$8.5 | -$13.5 | -$101.4 |
| **Equity Market Indices** | **03-Sep-18** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| S&P 500 | 2 902 | 0.93 | 2.15 | 8.52 |
| EuroStoxx 50 | 3 395 | -1.77 | -2.51 | -3.11 |
| CAC 40 | 5 414 | -1.19 | -1.19 | 1.91 |
| Nikkei 225 | 22 707 | -0.40 | 0.81 | -0.25 |
| Shanghai Composite | 2 721 | -2.16 | -0.72 | -17.73 |
| VIX - Implied Volatility Index | 12.86 | 7.26 | 10.48 | 16.49 |

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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