

STRATEGY WEEKLY

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A three-speed world

Key Points

- **Growth in the US contrasts with slowdown in the euro area and turbulences across emerging economies**
- **Modest rebound in US treasury yields (2.94%), Bund yields about 0.40%**
- **ECB: forced optimism and monetary pragmatism**
- **European equities fall, euro slide continues**

Risky asset markets fell last week. US stocks lost 1% whilst European equities plunged by about 3%. The decline in the euro (under \$1.16) is no longer supportive for European assets.

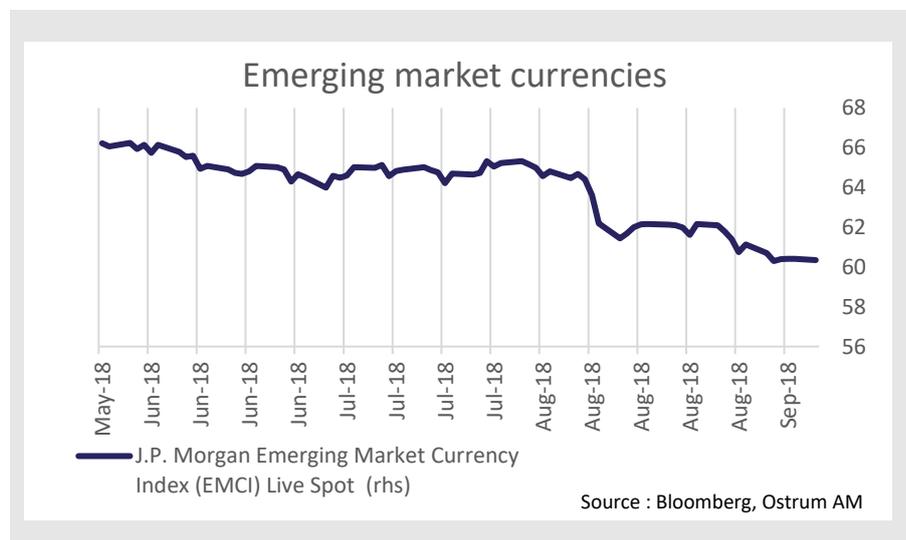
The currencies of emerging economies which are most exposed to international capital flows have remained fragile against the US dollar. South African rand and Indian rupee have weakened noticeably. Imported inflation is weighing on activity in several countries. Contrary to currency markets, emerging debt spreads have stabilised about 370bp.

Strong growth in the United States pushed Treasury yields higher (2.94% on 10-year notes).

Bund yields (0.40%) followed US Treasuries on the upside contributing to tighten sovereign spreads. Euro yields were up uniformly across maturities. The decline in risk premia is also traceable to reassuring commitments of Italian authorities regarding next year's deficit.

Credit spreads in euro remain elevated at 120bp vs. Germany. Outperformance of subordinated bank bonds resonates with relative performance from bank stocks. High yield is trading near 375bp, up 16bp since the start of the month. However, iTraxx Crossover is tightening to 286bp (-12bp last week).

Chart of the week



The JP Morgan emerging currency index is down 13% year-to-date.

Deterioration in current account balances of emerging economies amplifies the impact (both direct and indirect) of protectionism and higher US rates.

Most central banks have had to intervene in currency markets (India) and raise rates (Argentina, Turkey) with limited success so far, given contagion effects.

A three-speed world

Momentum in world trade has waned in the past few months. That said, all countries have not been affected to the same extent. The US economy maintains growth momentum well in excess of that of Europe, and of course of battered emerging markets in the wake of US trade restriction measures. Looming mid-term elections are unfavourable to global cooperation and could even trigger another episode of Federal government shutdown.

Employment in the United States (150-200k) keeps growing at a rate more than sufficient to absorb active population growth. The unemployment rate is still half a percent below the long-term norm (4.6% on Fed estimates). The Federal Reserve will likely raise rates by 25bp next week. Under current balance sheet policy, Fed asset holdings decline by \$40b a month. The pace of wind-down will rise to 50b a month in the fourth quarter but Jerome Powell has not yet made a decision on the appropriate pace of reserve cutback beyond the end of the year. At current pace, non-reinvestment will raise Federal government financing need by \$360b (1.8pp of GDP) on top of a projected fiscal deficit of about 5pp of GDP in 2019. Powell's next move, which may be unveiled in December, will have a considerable bearing on the US yield curve dynamics. The growth backdrop does argue for higher rates. In the short term, inflation will moderate somewhat (due to lower gasoline prices) and prevent yields to move swiftly towards fair value which we see at 3.05% or year highs at 3.12%. Short positioning does slow marginal upward pressure. Technically, current market levels could prove a turning point. Ten-year yields closing above 2.94% may entail a sell signal.

In equity markets, despite a 1% drop last week, the S&P index remains buoyed by high earnings growth and stock repurchase programmes. Such buybacks have been funded in part by corporate cash repatriation in the wake of last year's tax reform. On Fed estimates, corporations have repatriated more than 300b in 1Q18. In total, cash returned to shareholders in the form of dividend and stock purchase exceed 4% of market value over one year. Firm dollar also validates safe haven status of US equities within global equity portfolios. At the sector level, we nevertheless see some rotation out of technology in the past month.

ECB: questions around reinvestment policy

In the euro area, economic slowdown depicted in surveys since last winter is materialising. Industrial output in the euro area is growing at a 1% rate over the past year. Factory orders in Germany have indeed

turned around. Equities plunged logically last week (down 3%). Euro weakness is traceable to Italian woes and protectionist threat out of the US.

Credit on shaky grounds

Credit spreads (120bp) failed to tighten despite ongoing support from quantitative easing. The expected return of issuance in September and reallocations onto short-term credit funds highlight a market backdrop that is less favourable risk-taking. Demand for short-dated credit is a key reason behind the sharp narrowing in 2-year swap spreads. Surprisingly, banking subordinated debt have outperformed both senior bonds and industrial and defensive sectors. The move echoed outperformance of bank stocks across European stock markets after a prolonged period of weakness. The ECB may take account of the growth slowdown and cut back its 2019 forecast. Inflation is in line with the 2% target but will likely diminish towards 1-1.5% underlying inflation in the months to come. Mario Draghi will sound cautiously optimistic keeping cards close to his chest as regards QE reinvestment for some time. Amounts to be redeployed linked to PSPP holdings total €147b over the coming 12 months relative to just €5b for corporate debt, which could spell trouble for credit markets. Italy continues to try to reassure markets before the release of its three-year fiscal consolidation programme on September 27. Spread volatility remains elevated due to issuance and likely rating downgrades. BTPs are trading near 250bp on 10-year maturities. In parallel, Bund yields have crept higher to 0.40%. Another upward shift would require yields closing above 0.42%. The 10s30s spread did not react to long bond issuance in France (€1.25b maturing in 2066 at 1.81%) and Spain (€880m maturing in 2048 at 2.58%) last week. We keep a neutral duration stance.

Current account weigh on emerging currencies

The fall in emerging market currencies contrasts with relative stabilization in sovereign credit in US dollars. Currencies of countries which are most exposed to international capital flows have been hit hardest. This is the case for the South African Rand, which has now fully retraced 1Q18 strength. Argentina despite its monetary response (pushing yields up to 60%) remains fragile due to dollar demand from residents. President Macri cannot stabilize the situation for the time being despite securing IMF help and making spending cuts. However, the situation is less extreme in bond markets. Flows basically balance out and EMBI spreads hover about 370bp against Treasuries.

Main Market Indicators

G4 Government Bonds	10-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.54 %	+6	+9	+8
EUR Bunds 10y	0.40%	+7	+8	-3
EUR Bunds 2s10s	95 bp	+1	-1	-11
USD Treasuries 2y	2.71 %	+8	+10	+82
USD Treasuries 10y	2.93 %	+7	+6	+53
USD Treasuries 2s10s	22 bp	-1	-4	-30
GBP Gilt 10y	1.47 %	+7	+23	+28
JPY JGB 10y	0.12 %	+0	+2	+7
€ Sovereign Spreads (10y)	10-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	31 bp	-5	-4	-5
Italy	251 bp	-32	-17	+92
Spain	105 bp	-7	-4	-9
Inflation Break-evens (10y)	10-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	138 bp	+0	-1	-5
USD TIPS	210 bp	+1	+0	+12
GBP Gilt Index-Linked	304 bp	-4	-4	-2
EUR Credit Indices	10-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	120 bp	+1	+10	+34
EUR Agencies OAS	49 bp	-3	+1	+11
EUR Securitized - Covered OAS	50 bp	-3	-2	+10
EUR Pan-European High Yield OAS	375 bp	+16	+22	+81
EUR/USD CDS Indices 5y	10-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	61 bp	-7	-6	+17
iTraxx Crossover	282 bp	-16	-20	+49
CDX IG	60 bp	0	-1	+11
CDX High Yield	331 bp	+1	-2	+24
Emerging Markets	10-Sep-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	368 bp	-2	+33	+83
Currencies	10-Sep-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.160	+0.13	+1.76	-3.42
GBP/USD	\$1.303	+1.4	+2.26	-3.54
USD/JPY	¥111.13	+0.24	-0.38	+1.4
Commodity Futures	10-Sep-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$77.2	-\$0.9	\$4.1	\$13.2
Gold	\$1 195.8	\$2.4	\$2.2	-\$107.0
Equity Market Indices	10-Sep-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 877	-0.83	1.55	7.62
EuroStoxx 50	3 309	-2.52	-3.41	-5.56
CAC 40	5 270	-2.66	-2.68	-0.81
Nikkei 225	22 373	-1.47	0.34	-1.72
Shanghai Composite	2 669	-1.88	-4.50	-19.28
VIX - Implied Volatility Index	14.29	11.12	8.59	29.44

Source: Bloomberg, Ostrum Asset Management

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