STRATEGY WEEKLY

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ECB reinvestments to be debated in 4Q

Key Points

- **Risky assets rebound, T-note yields near 3%**
- **Western markets bounce, Nikkei benefits from weaker yen**
- **Markets ignore US fiscal slippage**
- **ECB: reinvestment policy to be debated in 4Q 2018**
- **Emerging markets take a breather following Turkey's rate hike**

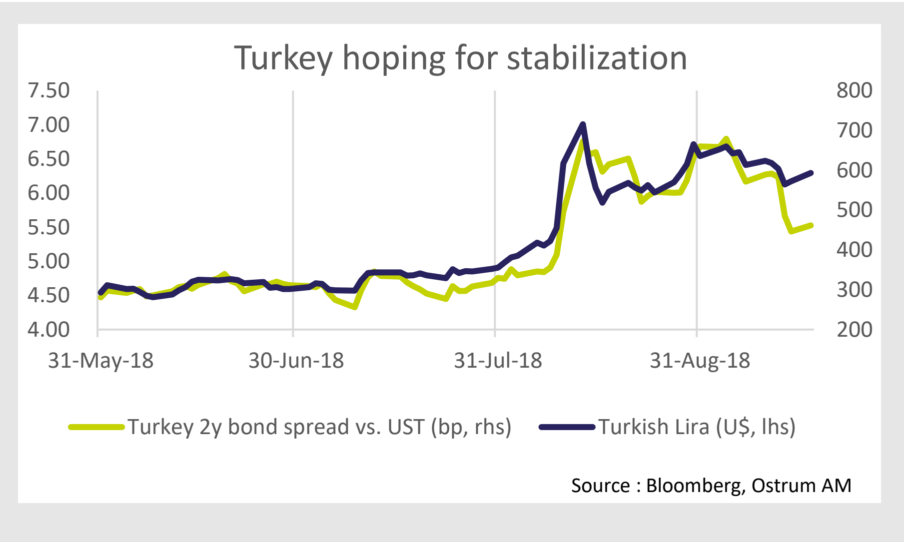
Equity markets moved higher last week. The US S&P index gained 1% whilst Japan's Nikkei went up fully 3.5% thanks to a weaker yen. Ten-year note yields flirt with 3% in the US propelling Bund yields higher towards 0.45% (+6bp). Shanghai remains under pressure given uncertainty surrounding the US trade strategy.

The ECB postponed any announcement regarding the reinvestment policy. Sovereign spreads tightened in the euro area. Selling pressure eased in Italy (241bp) ahead of the release of the stability programme. Credit spreads came in as well as risk-free bond yields rose. Credit markets offer a yield premium of 116bp over Bunds. Subordinated financials (including insurance are outperforming.

Emerging debt spreads have eased. Turkey's central bank raised rates bvy 625bp to 24% rejecting Erdogan's call for lower rates. The lira stabilised and dollar-denominated spreads eased. The average spread in the emerging asset class closed at 356bp last week.

The dollar has been trading sideways. The euro oscillates between $1.16 and $1.17. The Mexican peso was former and is now below 19 against the greenback. Conversely, looming elections take a toll on Brazil's real.

Chart of the week



Turkey's central bank raised interest rates by 625bp to 24% last week. The increase occurred amid government pressures threatening the institution's credibility and independence.

The bank had no choice but hiking rates to halt the downward spiral in the currency. The fall in the exchange rate already contributes to the sharp growth slowdown.

Two-year spreads have come in in the wake of the rate hike.

Equities rebound before Fed meeting

Economic growth remains elevated in 3Q18. GDP may have increased at a 4.4%qa rate in the three months to September according to Atlanta Fed estimate. Labour market conditions are extremely buoyant. Job openings totalled 6.9mn in July. Hiring difficulties are reported as the number of unemployed persons has fallen below the level of job vacancies. Furthermore, surveys of firms show considerable pressure on compensation across a lot of sectors.

There are however a few caveats. The federal budget deficit increased to $675b in the January-August period, matching last year's full-year total. Corporate tax collection (the bulk of which was collected on September 15) explains the bulk of the budget shortfall, which could reach 875b this year (4.3% of GDP). Economic policy is massively pro-cyclical, which only exacerbates structural issues in the US economy. Twin deficits are reappearing. Furthermore, housing is slowing. Price increases and higher mortgage rates combine to restrain housing investment demand. Growth will surely slow in the fourth quarter.

In this context, US 10-year yields have crept higher towards 3%. The Fed will communicate in the near future, possibly as early as next week, regarding the appropriate pace of balance sheet unwinding in 2019 and the number of hikes to be expected. What's at stake goes beyond policy management. It is a matter of independence of monetary policy vis-à-vis the Trump administration's fiscal policy choices that greatly reduce leeway in the event of a sharp economic downturn. Current yield valuations (2.99%) are close to our fair value estimate (3.05% on 10-year note), so that a move up to 3.05% or possibly previous highs of 3.12% appear likely in the short run. This leads us to recommend a short stance on Treasuries.

US equity markets remain well oriented, despite uncertainty surrounding trade talks with China. Fiscal reform greatly benefits shareholders via buyback programmes amounting to more than 2% of the market capitalization in the past year. Implied volatility levels have dipped back to 12% on a one-month horizon. In addition, the growth factor remains a dominant theme. The price-earnings valuation gap to value stocks is indeed 8 figures at present.

ECB reinvestments to be discussed…

In the euro area, Mario Draghi indicated that the ECB's reinvestment policy will be discussed in October or December. Inflation forecasts (1.7% until 2020) appear to factor in a pickup in core inflation that remains to be seen. Inflation stripped out of volatile items was just 1%y in August. That said, Bund yields moved up in the wake of US Treasuries is now trade close to the upper end of their range. A break above 0.50% would entail a sell signal which the ECB may wish to fight by alluding to twist (reinvestments onto longer maturities) in a bid to shelter euro bonds from upward pressure on US yields. A short stance is appropriate in the short run. The risk-free yield rise was accompanied by easing tensions in Italy. Ten-year BTP spreads have narrowed below 250bp. Markets wants to believe in fiscal consolidation next year. The devil is always in the detail: the 2019 growth assumption and forecasted cash collection from tax evasion fight will be under market scrutiny. The verdict will come on September 27. Improved sentiment may prove short-lived and we maintain a short stance. In parallel, S&P raised the outlook of Portugal's sovereign rating to positive. Portuguese spreads came in below 140bp on 10-year maturities.

As perception of Italian sovereign risk improved, most euro-denominated assets performed better. The euro-dollar exchange rate consolidated above $1.16. Equity markets bounced by about 1% last week and euro credit spreads narrowed to 116bp vs. Bunds. Outperformance of financials securities (banks, insurers) was evident in both equity and credit markets. Subordinated debt of insurance companies returned 0.8% last week. In equity space, European banks gained 2.4%.

In the UK, Mark Carney's term as BOE governor will be extended to January 2020. The institution which held rates unchanged last Thursday is openly worried about the possibility of no-deal Brexit.

Emerging markets take a breather

Turkey's central bank raised interest rates by more than most market participants had expected. The one-week repo rate increased from 17.75% to 24%. The uncontrolled currency depreciation through the summer required monetary overkill to stem self-fulfilling speculation to the downside. The government also took soft capital control measures to enhance the use of local currency in domestic transactions. The decision help prop up dollar-denominated debt as spreads tightened from about 600bp before the meeting to around 450bp. That said, Turkey's economic slowdown will be brutal.

This does represent broader dynamics across emerging market space. Selling pressure was particularly harsh in currency and equity markets whilst flows balance out in both hard-currency and local-currency sovereign bond ETF markets. The average spread in the asset class is now 356bp against US Treasuries.

Main Market Indicators

G4 Government Bonds	17-Sep-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.53 %	+2	+12	+10
EUR Bunds 10y	0.46%	+6	+15	+3
EUR Bunds 2s10s	99 bp	+4	+3	-7
USD Treasuries 2y	2.78 %	+7	+17	+89
USD Treasuries 10y	2.99 %	+6	+13	+59
USD Treasuries 2s10s	22 bp	0	-4	-31
GBP Gilt 10y	1.54 %	+7	+30	+35
JPY JGB 10y	0.12 %	+0	+2	+7
€ Sovereign Spreads (10y)	**17-Sep-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	31 bp	+0	-5	-4
Italy	239 bp	-12	-43	+80
Spain	103 bp	-2	-11	-11
Inflation Break-evens (10y)	**17-Sep-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	139 bp	+1	+0	-4
USD TIPS	211 bp	+1	+2	+12
GBP Gilt Index-Linked	305 bp	+2	-1	-1
EUR Credit Indices	**17-Sep-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	116 bp	-4	+3	+30
EUR Agencies OAS	48 bp	-1	-4	+10
EUR Securitized - Covered OAS	48 bp	-2	-7	+9
EUR Pan-European High Yield OAS	364 bp	-11	+3	+70
EUR/USD CDS Indices 5y	**17-Sep-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	60 bp	-1	-11	+15
iTraxx Crossover	282 bp	0	-24	+49
CDX IG	56 bp	-3	-5	+7
CDX High Yield	317 bp	-10	-17	+10
Emerging Markets	**17-Sep-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	356 bp	-13	-9	+71
Currencies	**17-Sep-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.169	+0.88	+2.02	-2.62
GBP/USD	$1.316	+1.2	+2.94	-2.59
USD/JPY	¥111.93	-0.28	-1.45	+0.68
Commodity Futures	**17-Sep-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$78.2	$0.8	$6.1	$14.1
Gold	$1 201.9	$6.3	$12.7	-$100.9
Equity Market Indices	**17-Sep-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 894	0.59	1.54	8.24
EuroStoxx 50	3 346	1.11	-0.80	-4.50
CAC 40	5 349	1.50	0.07	0.68
Nikkei 225	23 095	3.53	3.70	1.45
Shanghai Composite	2 652	-0.66	-0.64	-19.82
VIX - Implied Volatility Index	13.04	-7.91	3.16	18.12

Source: Bloomberg, Ostrum Asset Management

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